

SCENARIO ANALYSIS 2022: POTENTIAL POLITICAL RISKS FACING FOREIGN INVESTORS IN THE PRC

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DECLARATION

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

.....28 November 2002.....

Date

ABSTRACT

Since the beginning of the economic reforms in 1978, the People's Republic of China (PRC) has attracted continuous interest from foreign investors, both in the form of foreign direct investment (FDI) and international trade, making the PRC the second largest host of FDI in the world. Despite occasional declines in foreign investment, foreign investors remain very interested in the long-term prospects for doing business in the country. The PRC's phenomenal economic growth, large consumer market, the accession to the World Trade Organisation (WTO), and the government's commitment to open markets, economic reforms, and restructuring of the economy are amongst the factors that continue to attract foreign investment and trade.

Despite the huge market potential and strong desire by foreign investors to do business in The PRC, the track record of foreign companies and investments in the country have at best been mixed. While some foreign investors have reaped large profits, others have failed to meet their performance targets. Foreign investors have faced a number of problems that are not market or trade related, but associated with economic, political and social trends and developments, including corruption, nepotism, crime, poor infrastructure, a depleted banking system, inefficient legal system, unemployment and poverty. Therefore, it is not surprising that many foreign investors are asking themselves whether the benefits of doing business in the PRC are worth the risks.

In an increasingly uncertain and instable international trade and investment environment political risk assessment and management have become essential components of any profitable foreign investment strategy. Consequently, numerous political risk-rating agencies and a large number of both qualitative and quantitative risk assessment methods have emerged over the years. There is, however, neither general consensus regarding the definition of political risk nor a comprehensively systematic method of conducting political risk assessment. The definitions of political risk include a wide variety of indicators, ranging from governmental actions to all non-market developments. The number of methods available for political risk analysis range from informal, unsystematic assessments by a few individuals to formal, systematic, and sophisticated risk analysis models. There are, however, some similarities. The main objective of political risk analyses is to describe, explain, and forecast

political conditions and events that affect the interests of foreign investors operating abroad or planning to enter a foreign market. In addition, political risk analyses attempt to forecast losses, and recommend means of managing the risk, avoiding the losses, and seizing the opportunities.

Scenario planning is one of the qualitative methods used to analyse political risk. Scenario planning, however, differs from most other approaches as it does not try to accurately predict what will happen in the future or to provide the right tool for foreseeing the future developments, but to offer a range of possible futures. The underlying assumption is that the future cannot be forecast or predicted with certainty, but that the very process of thinking about the future and exploring the implications of possible future scenarios may have a profound impact on foreign investment and trade.

Scenario planning is a method that provides insightful information necessary to understand, anticipate and respond to change and uncertainty in the future PRC. The development of four 20-year scenarios in this study demonstrates that the prospects for foreign investment can be both positive and negative. When the economy continues to grow strongly, and the government is able to maintain a stable environment and successfully implement the necessary changes foreign investors are expected to reap the desired benefits. However, if the problems facing the PRC at the moment further deteriorate foreign investors could expect increased risks, and the possibility of failure.

OPSOMMING

Vanaf die begin van die ekonomiese transformasie in 1978, het die Volksrepubliek van Sjina voortdurende belangstelling van buitelandse beleggers geniet. Hierdie belangstelling was gemanifesteer in die vorm van direkte buitelandse belegging asook internasionale handel. Sjina het so aanloklik vir buitelandse beleggers geword, dat dit tans die wêreld se tweede grootste ontvanger van buitelandse belegging is, en beleggers stel veral belang in die lang termyn moontlikhede van besigheid doen in die land. Die Volksrepubliek van Sjina se merkwaardige ekonomiese groei, groot verbruikersmark, toetreding tot die Wêreld Handels Organisasie, en die regering se verbintenis aan die ontwikkeling van 'n oop ekonomie, ekonomiese transformasie en die herstrukturering van die ekonomie as sulks, is sommige van die faktore wat toenemend buitelandse belegging en handel aanlok.

Ten spyte van die groot verbruikersmark potensiaal en die sterk begeerte van buitelandse beleggers om besigheid te doen in die Volksrepubliek van Sjina, is die ervarings van buitelandse maatskappye tot dusver gemeng. Alhoewel sommige buitelandse beleggers groot wins gemaak het, het ander minder sukses ervaar. Buitelandse beleggers word ook gekonfronteer met baie probleme wat nie noodwendig met die mark of handel gepaard gaan nie. Hierdie probleme word geassosieer met ekonomiese, politieke en sosiale gebeure en faktore insluitend korrupsie, misdaad, nepotisme, swak infrastruktuur, 'n ledige bank sisteem, 'n ondoeltreffende regssisteem, werkloosheid en armoede. Baie buitelandse beleggers betwyfel dus moontlik die vraag of besigheid doen in die Volksrepubliek van Sjina tog meer voordele inhou as risiko.

In 'n wêreld waar internasionale handel en belegging met onsekerheid en onstabiliteit gepaard gaan, het die aspekte van politieke risiko skadebepaling en -bestuur belangrike komponente van enige winsgewende buitelandse belegging strategie geword. Gevolglik het verskeie politieke risiko-analise agentskappe asook 'n verskeie risiko-analise metodes van beide kwantitatiewe en kwalitatiewe aard hul verskyning gemaak. Ten spyte van die bogenoemde is daar nog steeds geen veralgemende konsensus oor die definisie van politieke risiko, of 'n oorsigtelik sisteematiese metode van politieke risiko-skatting onderneem nie. Die definisies van politieke risiko sluit in 'n groot verskeidenheid van indikatore wat wissel van regeringaksies tot mark-onverwante gebeure. Die verskeidendheid van metodologieë wat gebruik word in politieke risiko-analise wissel van informeel, onsistematiese skattings, tot

formele, sisteematiese en gesofistikeerde risiko-analise modelle. Die primêre doel van politieke risiko-analise is om te beskryf en te verduidelik, en ook om politieke omstandighede en gebeurtenisse wat die belangstelling van buitelandse beleggers affekteer te voorspel. Addisioneel beoog politieke risiko-analise om ook die moontlikheid van verlies te voorspel en om 'n strategie vir die bestuur van die risiko aan te beveel, om sodoende verlies so ver moontlik te vermy asook om moontlike geleenthede aan te gryp.

Senariobepanning is een van die kwalitatiewe metodes wat gebruik kan word in die analise van politieke risiko. Senariobepanning verskil van ander benaderings in die sin dat dit nie akkurate voorspellings vir die toekoms as sulks maak nie, maar eerder 'n verskeidenheid van moontlike toekomstige omstandighede weergee.

Die ontwikkeling van vier 20-jaar senarios vir die Volksrepubliek van Sjina in hierdie studie illustreer hoe die uitsigte vir buitelandse belegging positief sowel as negatief kan wees. Indien die Sjinese ekonomie verder groei en die regering in staat is om 'n stabiele omgewing in stand te hou asook die nodige veranderinge te implimenteer, kan buitelandse beleggers verwag om beoogde voordele van buitelandse belegging te ervaar. Maar as die probleme wat die Volksrepubliek van Sjina op die oomblik ervaar voortduur en/of verswak, kan buitelandse beleggers verhoogde risiko sowel as die moontlikheid van mislukkinge verwag.

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CHAPTER 1

Introduction

1.1. Introduction

The aim of this research assignment is to explore political risks and opportunities that foreign investors in the PRC might face in 2022. This assignment will illustrate how forecasting method called scenario-planning can be applied to the study of political risk, and further developed into an uncomplicated political risk analysis method that can be easily utilized by larger or smaller companies or individual investors, resulting in good and sound investment decisions.

The 21st century world of international trade and investment can offer a wealth of opportunities. Benefits range from new buyer and supplier markets to superior or less costly access to both inputs of production and strategic assets such as distribution networks or new technology (CSIS, 2002: 1).

As the international trade and investment figures for the past twenty years show, the growth pace of international trade and investment has been rapid. In 1982, the global total of Foreign Direct Investment (FDI) flows was \$57 billion (CSIS, 2002: 1). By the year 2000, that number had grown to \$1271 billion - nearly twenty times the level two decades earlier (CSIS, 2002: 1). International trade has also been growing rapidly at an annual rate of five percent (CSIS, 2002: 1). The emerging markets, in particular, have benefited from the fast growth rates due to their high GDP growth rates, commitment to reform the financial and accounting systems, and the adaptation of neoliberal economic policies, including deregulation and privatisation (Summit Analytical Associates, 2002: 1).

One of the new emerging markets that has attracted much attention from foreign investors over the past twenty years is the People's Republic of China. Interest in the PRC has steadily been increasing as the PRC and the Chinese Communist Party (CCP) have gradually opened up to the outside world. Since the start of the reforms under the regime of Deng Xiaopeng in 1978, the PRC has sustained an average economic growth of over 10 percent annually, and attracted 38 percent of the total Foreign Direct Investment (FDI) to developing countries. Additionally, more than 200 of the world's top 500 multi-national corporations have established operations in the PRC (Henley & Kirkpatrick: 1999: 1).

Although the international trade and investment environment has been rewarding for many investors it has not always been risk-free. This has been clearly demonstrated in a number of financial crises during the past ten years, including the Mexican market crash in 1994, the Asian Financial Crisis in 1997, and the financial crisis in Argentina in 2001. As a result, many investors have realised over the years that non-market developments, namely political, social and cultural phenomena, ranging from civil unrest to regime change, currency devaluation and taxation policy can indeed have a huge impact on foreign trade and investments.

Many foreign investors in the PRC would agree that non-market developments do influence foreign trade and investment. Although foreigners have invested large amounts in the Chinese economy over the past twenty years, the profitability of doing business in the PRC has always been controversial (Schlevogt, 2000: 2). While some foreign investors have reaped large profits, others have failed miserably (Schlevogt, 2000: 2). Foreign investors have faced a number of problems affecting their business operations, including corruption, nepotism, crime, bankruptcies, poor infrastructure, unproductive state enterprises, a depleted banking system, and social problems such as unemployment and poverty. Thus, it is no surprise that many foreign investors are asking themselves if the benefits of conducting business in the PRC are worth the risks involved. Although the PRC has proved that it is taking trade liberalization seriously and that it is committed to the economic and social upliftment of its people, the CCP is still firmly in control of all the aspects of political and economic life. The government understands the vital importance of strengthening the unity of various ethnic groups, and maintaining social stability, however, it appears that the CCP will not be afraid to use its state power to maintain strict control and repress social protest, opposition parties and the media that might oppose its rule in the future. The lack of political freedom and democratic rule are factors that concern many foreign investors. Many are afraid that the political, social, and economic problems facing the country could lead to widespread protests and social unrest. And thus, many are asking themselves the question: 'is it wise to make investments in a country that is challenged by so many political, economic and social uncertainties and instabilities?'

As a result of increased uncertainty and instability in the international trade and investment environment the need for political risk assessment has been steadily growing over the past twenty years. Consequently, numerous political risk-rating agencies have emerged, and many multi-national corporations (MNCs) have created their own systematic in-house political forecasting systems (Kennedy, 1991: v; Simon, 1982: 65). Additionally, most credit rating

agencies and international banks now consider political risk assessment as one of the aspects needed for a comprehensive risk assessment.

Political risk analyses, indeed, are useful for any internationally oriented business or organization, whether in corporate, governmental or non-governmental sector. Political risk analyses provide insightful information that is necessary to understand, anticipate, and respond to change and uncertainty in an increasingly complex global world. People responsible for making decisions or advising decision-makers on any aspect of investment, therefore, need to have a knowledge of both risks and opportunities in a given country. Although the future cannot be forecast or predicted with certainty, it is suggested that the very process of thinking about the future or exploring the implications of alternative futures is believed to have a profound positive impact on foreign investment. By analysing future risks and opportunities, the future investment environment may be influenced or shaped to some extent.

The political risk assessment methods used by risk rating agencies and the private sector range from unsystematic, qualitative assessments by a few individuals to systematic, quantitative and sophisticated risk analysis models (Mascarenhas & Atherton, 1982: 22; Nelson, 1999: 26). The current political risk assessment methods, however, present a number of problems and limitations, particularly for small and medium-sized businesses and organisations.

Firstly, the majority of current risk assessment methods emphasise financial and economic risks. As mentioned earlier, however, political risks are as important, if not even more important as financial risks. For instance, one of the main reasons why so many risk rating agencies, including Moody's and Standard & Poors, failed to predict the Asian financial crisis accurately and timely was because political risk indicators were overlooked, underestimated or excluded from their risk rating models, and too much emphasis was put on financial indicators (Brink, 2002).

Secondly, the majority of political risk assessment methods concentrate on analysing the macro risks - events and developments that are broadly directed at all foreign firms in a host country (Fitzpatrick, 1983: 249-254; Frei & Ruloff, 1988: 3; Chicken, 1996: 122-123; de la Torre & Neckar, 1988: 222, 228). Nevertheless, the greatest potential lies in political risk analyses that consider both macro and micro risks (risks specific to an industry, a firm, a

project, or even an individual) (Fitzpatrick, 1983: 249-254; Frei & Ruloff, 1988: 3; Chicken, 1996: 122-123; de la Torre & Neckar, 1988: 222). Macro risk reports are not always useful for individual firms planning to invest in a foreign country. They provide relevant background information, but cannot respond to issues and decisions which an individual firm may be facing.

Many foreign investors planning to do business in the PRC are confronted by these two problems. The mainstream political risk agencies provide country reports that deal with a variety of economic and financial risks, but largely ignore the potential political risks. The industry-specific risk reports are much harder to come across, and are usually very costly. Risk reports that deal with issues important to an individual company are nonexistent. Thus, it is not surprising that many investors are very concerned about their investment options and profitability of potential investments in the PRC.

Considering the problems with the conventional political risk analysis methods this assignment introduces, examines, and then utilizes a long-term planning and forecasting method known as scenario planning. Although scenario planning is predominantly used as a part of the organizational learning process, strategic decision-making or management approach, several risk-rating agencies utilize scenario planning approach to conduct political risk assessment (Business Futures, 1997: 25; Ingram, 1993: 1; Schoemaker, 1993: 193-213; van der Heijden, 1998: 1; MetaBridge, 1996: 1; Bain & Company, 2002: 1; De Geus, 1998: 71).

Scenario planning differs from most other political risk assessment approaches to forecasting in two ways (Schnaars, 1987: 154). Firstly, scenario planning is a qualitative approach (Schnaars, 1987: 154; Wilson, 1998: 353). Secondly, the scenario planning method does not attempt to accurately predict what will happen in the future, but to offer a range of possible futures, each of whose occurrence is plausible but not assured (Schnaars, 1987: 154; Business Futures, 1997: 25; Swartz, 1999: 6; Wright, 2000: 1; Coles, 2000: 1; Fahey & Randall, 1998: 4; Challenge Forum, 2001: 1; Epstein, 1998; South Wind Design, 2001: 1; Kairos Future, 2002: 1; Kenter, 1998: 1; Ashley & Morrison, 1996: 1; Fein, 2002: 1; Kleiner, 1999: 1; Wilkinson, 2002: 1; NATO, 2002: 1; College of Marin, 2002: 1; Finland Futures Research Centre, 2001: 1; Granger, 1989: 224; Wack, 1985: 146).

The main objective of scenario planning is to provide scenarios, which are fundamentally different futures presented in the form of a narrative or a story (Schoemaker, 1993: 195). Scenarios help decision-makers to identify the key political, economic, social and other (such as technological, cultural, environmental, psychological) driving forces; potential political, economic and social scenarios and outlooks for the future over a predetermined period of time; and likely risks and opportunities under each scenario (Oxford Analytica, 1997: 1; Linneman & Kennell, 1977: 141, Schwartz, 1996: 2-3; Wright, 2000: 1; van der Heijden, 1996: 2; Wack, 1985: 139).

Scenario planning method is best suited for identifying possible business opportunities, and threats, anticipating and preparing for change and uncertainty, and conducting long-range planning and forecasting (Fahey & Randall, 1998: 4; van der Heijden, 1998: 335; Bonnett & Olson, 1998: 309; Wright, 2000: 1; Coles, 2000: 1; Fahey & Randall, 1998: 3, 12; Marsh, 1998: 39; Wilson, 1998: 81; Perrottet, 1998: 123; Fahey, 1998: 191; Swartz, 1999: 9; Brundle, 2002: 1; Kenter, 1998: 1: 1; Ashley & Morrison; 1996: 35-50; Fein, 2002: 1; van der Heijden, 1997: 1; Bures, 2002: 1; GBN, 2002: 1; Wack, 1985: 74; De Geus, 1988: 71; Bood & Postma, 1997: 636). Scenario planning approach is the most advantageous when uncertainty is high, and most suitable for longer time spans (Schnaars, 1987: 165; Morrison & Wilson, 1997: 1; Business Futures, 1997: 26; van der Heijden, 1997: 1). Scenario planning method is also highly flexible. It can be used to analyse both macro and micro risks, and easily adapted to the needs of the specific situation.

Taking into consideration the advantages of scenario planning the approach is ideal for foreign investors that are concerned about their investment options and profitability of potential investments in the PRC. Scenario planning gives foreign investors the best possible leverage in advance to deal with a wide range of potential future developments and outcomes, and to consider possible responses and ways of reacting to anticipated risks (Ilbury & Sunter, 2001: 42; Courtney, Kirkland & Viguerie, 1999: 9; Joyce & Woods, 2001: 190; Ringland, 1998: 1).

1.2. Problem Statement

Is it wise to make investments in a country such as the PRC that is riddled with so many uncertainties and potential risks? Foreign investors certainly would be more than delighted to get an answer to this question. This is, however, the kind of question that is very difficult or

perhaps impossible to answer. Political uncertainty and instability are not necessarily signs of potential risk to the investor. The political risk literature has, indeed, provided plenty of contradictory evidence and argues that political instability can actually improve the business climate (Kobrin, 1978: 114).

Although, this assignment cannot directly answer the question if the returns of doing business in the PRC are worth the risks, it will aim to take a closer look at potential future political threats facing foreign investors in the PRC. The research questions that this assignment will undertake are the following:

- What are the potential political risks foreign investors or business people will face in the future PRC?
- What are the alternative futures for foreign investment and trade in the PRC?
- Is there potential that the political risks will outweigh the investment and business opportunities in the future PRC?
- Under what conditions will political risks be greater than investment or business benefits?
- What will be the best methods of managing political risk in the future PRC?

1.3. The Purpose of the Study

In view of the stated research questions, the purpose of this assignment is to present a detailed picture of investment and trade opportunities and threats in the PRC. In other words, to describe, explain, evaluate, and forecast the possibility of political conditions, events and trends that will affect the interests of foreign firms operating in the PRC or planning to enter the PRC's consumer market. This research study is not centrally concerned about testing a particular hypothesis, but strives to understand the holistic picture – a great variety of views and perspectives – regarding foreign investment in the PRC.

This assignment concentrates on the political risk that foreign business might face, be it direct foreign investment, import and/or export operations, private banks, joint ventures or agents operating in the PRC. The aim is to illustrate how the forecasting/long-term planning method called scenario planning may be applied to the study of political risk, and further developed into an uncomplicated political risk analysis method that can be easily utilized by larger or smaller companies or individual investors, resulting in good and sound investment decisions. The premise of the assignment is that the future might not completely coincide with any of the

proposed scenarios, but the scenarios do establish a sufficiently broad range of possibilities for purposes of foreign investment.

The four scenarios developed in this assignment illustrate four possible futures for the PRC. The first scenario, 'Investor's Paradise', presents a picture of an economically viable and democratic the PRC in year 2022. The second scenario, 'Turbulences', portrays the PRC as a country troubled with a weak economy and a struggling democracy. In the third scenario, 'Golden Cage', the PRC's political system remains the same, coupled with high economic growth. And the last scenario, "Revolution", depicts a story of the PRC under tightening authoritarian rule and the pressures of a weak economy.

1.4. Method of Research

This study is a descriptive and explanatory single case study. Its main unit of analysis: - the PRC will be in examined in detail within its real-life context. As case studies are usually "multi-perspectival analyses" a number of perspectives will be considered (Tellis, 1997: 1). In the case of the PRC, this means that not only the voices, interactions, and perspectives of the prominent actors (government, the media) are not considered as the only sources of information, but that a voice will be given to various other actors.

Although a large number of both qualitative and quantitative political risk models and approaches are available to be utilized in political risk analysis, this study will introduce and employ a qualitative approach known as scenario-planning to construct a political risk assessment on the PRC.

The qualitative and quantitative secondary data used in this study will be collected from reputable newspapers, surveys, academic journals, census data, documents, statistics, and the Internet sources.

Although the study will mainly focus on political risk factors in the PRC, other non-market forces (economic, social, cultural, technological, environmental, and even psychological) affecting the business environment will be considered and monitored. Similarly, despite the fact that the main level of analysis is the host country environment, various other environments (home country, international, regional, global, industry, and company) will be taken into consideration in the scenarios.

There exists no universally accepted method for constructing scenarios as scenarios are usually developed for a specific purpose (Spies, 1982: 15; Swartz & Ogilvy, 1998: 67; van der Heijden, 1997). To produce the scenarios for the future of investment in the PRC, this assignment will employ a six phase approach to scenario planning, that features many of the common concepts found in the writings of leading scenario-planners including Swartz, Ringland, and van der Heijden. Four 20-year scenarios will be constructed around four possible paired combinations of the following critical uncertainties: economic growth/slowdown, and democratic/authoritarian governance. The process will start with the identification and analysis of key organisational decisions that will provide the focus for the scenarios, and concludes with the analysis and interpretation of the scenarios for their decision implications.

The basic structure of this assignment is the following. Firstly, in order to summarise the development of prior research, and to demonstrate a familiarity with both political risk analysis and scenario planning, a detailed literature review will be constructed on both topics. Secondly, the political risk analysis model based on the scenario planning method will be presented in detail. Thirdly, the improved step-by-step scenario planning method will be applied to the case study country. And lastly, the foreign investors planning to do business in the PRC will be provided with sound risk management strategies and the best investment alternatives available.

1.5. Limitations

The qualitative nature of the study will consequently pose several limitations and problems. The results of this qualitative study will be less easily generalised or replicated in another setting. Additionally, aggregating data and making systematic comparisons will be difficult. This study will be dependent upon the author's personal attributes, opinions, judgments and skills, and the secondary data used in this study. Therefore, the analysis will be to some extent more subjective.

The secondary data used in this study poses another limitation. The main problem with the secondary data is that the researcher has no control over the production of such data as it was originally gathered by someone else (Babbie & Mouton, 2001: 77; Neuman, 1999: 305). Another problem often faced by researchers is that some of the collected data are missing, due to neglect or the fact that the data were never collected in the first place (Neuman, 1999: 309).

Additionally, the existing statistical data, particularly, can be erroneous, distorted, unreliable or falsely employed (Kobrin, 1981: 255). The source can give a false impression of accuracy by quoting statistics in greater detail than warranted (Neuman, 1999: 305). To find an appropriate unit of analysis can also be difficult as many statistics are published for aggregates, not the individual (Neuman, 1999: 305).

Problems with reliability can also plague existing statistical research. Reliability problems develop when official definitions or methods of collecting information change over time, or when official statistics of different national governments, whose data collection quality varies, is used for international comparisons (Neuman, 1999: 308). Validity problems, on the other hand, can occur when there are systematic errors in collecting, organising, reporting or publishing the initial information (Neuman, 1999: 306).

Although, the Internet is a great source of a wide variety of information, there are also a number of problems. Data collected from the Internet is sometimes of poor quality, undocumented, biased, made up or even fraudulent (Neuman: 1999: 463). In addition, documents and articles found on the Internet are often summarised and shortened versions of the original documents as the high-quality originals are not always freely accessible, and it is difficult to check the Internet references as the web addresses may be changed and removed at any time (Neuman: 1999: 463).

In order to increase reliability unambiguous, clear theoretical definitions and concepts will be constructed, and multiple indicators of measurement will be employed. To ensure accuracy and objectivity multiple sources of data will be used. The data will be obtained from well-researched publications and Internet sources to increase objectivity.

1.6. Outline of Chapters

The second chapter of this study will introduce the study of political risk analysis. The literature review will present prior research on political risk, and current political risk assessment methods and their limitations.

In the third chapter the scenario planning method will be described in detail - its history, approaches, assumptions, concepts and usage. The chapter will also introduce the six steps of scenario-planning that will be later utilized to study political risk in the PRC.

The fourth chapter will present a background for the study of the PRC. Historical setting, current economic, political and social trends, and foreign investment in and trade with the PRC will be reviewed in detail.

The last chapter is an illustrative case study of political risk in the PRC, in which four scenarios about will be constructed by using the basic six steps of scenario planning. The Chinese investment environment in 2022 probably will not completely coincide with any of the proposed scenarios, but the scenarios do establish a sufficiently broad range of possibilities for the future. Foreign investors can assess the implications of the scenarios and consider what risk management strategies to adapt now to best anticipate and affect future developments. The chapter will also summarise the study in a few words, and present some concluding remarks.

1.7. Summary

Foreign investment and trade in the PRC in recent decades has seen explosive growth. Some investors and business people have reaped great profits, while others have failed miserably primarily due to economic, political and social problems such as corruption, nepotism, crime, bankruptcies, poor infrastructure, unproductive state enterprises, a depleted banking system, and social instability caused by unemployment and poverty. As a result, many foreign investors planning to do business in the PRC are very concerned about political risks that might face them. To find out whether the political risks are greater than the opportunities and to learn more about political threats in general, political risk analysis may be performed.

This assignment will introduce a forecasting method known as scenario planning and utilize it to study political risks in the PRC. However, in order to fully understand political risk and various methods of analyzing political risk the next chapter will provide a detailed literature review of the topic.

CHAPTER 2

Political Risk Analysis: Some Background Information

2.1 Political Risk Analysis – A Growing Field

Literature on political risk only emerged in the late 1960's, and political risk assessment was given a low priority by most corporations and very few organizations conducted systematic evaluations of political risk until the early 1970's (Simon, 1982: 62).

Since political and economic turmoil and instability in the international environment in the 1970's, including the 1973 Oil Crisis, the overthrow of the Iranian Shah in 1979, and numerous other politically-motivated conflicts, as well as the growing interdependence of the international trading system, political risk analysis has been gaining support and acknowledgement as a discipline to be taken seriously (Graham, 1988: 69; Simon, 1982: 65; Brink, 2002). Consequently, over the years numerous political risk-rating agencies have emerged, and many MNCs have created their own systematic in-house political forecasting systems (Kennedy, 1991: v; Simon, 1982: 65). Most credit rating agencies and international banks also consider political risk as one of the aspects needed for a comprehensive risk assessment.

As the world in the beginning of the 21st century is still riddled with instability, uncertainty, and a number of serious problems, including the growing gap between rich and poor, depleting natural resources, increasing poverty and unemployment, escalation of ethnically and politically motivated violence, terrorism, the spread of HIV/AIDS and other contagious diseases, and intensifying environmental problems, it is likely that the political risk industry will continue to flourish and the study of political risk will receive more serious attention (Kloman, 2002: 1).

2.2 Political Risk Analysis in Brief

The aim of political risk analysis is to describe, explain, and forecast political conditions and events that affect the interests of firms operating abroad or which are planning to enter a foreign market (Brewer, 1985: 3; Howell, 1998: 3; Bergner, 1982: 28). Additionally, political risk analysis attempts to forecast losses, and recommend means of managing the risks,

avoiding the losses, and seizing the opportunities (Howell, 1998: 4,5; Brewer, 1985: 4; Kloman, Dec. 2001: 1).

Political risk analysis is a practical and useful tool, which is often used as an integral part of a company's strategic planning, and most importantly in conjunction with major investment-funding decisions (Kennedy, 1991: v & Bergner, 1982: 29). Political risk assessments are also frequently used for general background knowledge, evaluating risks to specific projects or investments, strategic planning activities, determining new business opportunities, divestment, day-to-day operations, briefing upper-level management, and making decision about security (Howell, 1998: 292).

2.3 The Importance of Understanding the Concepts and Methods Regarding Political Risk Analysis

Many authors in the field of risk analysis have raised the problem of inadequate understanding and development of concepts, definitions, theories and measurements of political risk (Sethi & Luther, 1987: 59 & Doyle and Brown, 1988: 10). The lack of a clearly defined conceptual framework leads to incompetent methods of gathering, evaluating and analyzing information, as well as inaccurate analysis and forecasting, which in turn, cost the investing firms money, and does damage to political systems or countries that do not receive investment (Howell & Chaddick, 1994: 72; Simon, 1984: 123). Several studies support this view.

A research study by Howell and Chaddick, who examined the ability of three political risk models to forecast losses in the 1987-1992 period, demonstrates that many of the existing political risk models fail to indicate significant correlation between the projection and the actual losses (Howell & Chaddick, 1994: 89; Chermak, 1992: 175).

A number of other studies have also shown that many people in the business sector do take into consideration political risks in assessing the total risk of a particular country (Broadfoot, 1998; Baker & Hashmi, 1988: 40-47; Kobrin, 1978: 113). However, corporate decisions on investment abroad are often based on the generalized perceptions of political risks in a particular country, and political instability is equated with political risk and a poor investment climate (Kobrin, 1978: 114). This partly explains the fact that the largest fraction of FDI still

goes to the developed economic areas, especially the United States and some countries in Europe (Gilpin, 2001: 7).

Therefore, it is not incorrect to conclude that a thorough understanding of political risk is needed in order to develop systematic and comprehensive methods to conduct political risk assessment.

2.4 Defining Political Risk

There are numerous definitions and variations of the concept political risk. As a matter of fact, there is no universally accepted definition of the term political risk (Miller, 1992: 311; Brummestead, 1988: 74; Torre & Neckar, 1988: 227; Robock, 1987: 86). Authors have defined political risk according to their different fields of study, whether it is economics, politics, social studies, or legal studies. Some of the definitions cover wider aspects of political risk, whereas others offer some intrinsic insight into the field of political risk.

Political risk is most frequently defined in terms of governmental or/and societal actions or interference, uncertainty about the political environment, events and developments in the non-market (political, economic, and social) environment of business, or occurrences and discontinuities of a political nature (Akhter & Lusch, 1987: 81-101; Bergner, 1982: 28; Brewer, 1985:3; Brummestead, 1988: 79; Chermak, 1992: 167-179; Fitzpatrick, 1983: 249; Frei & Ruloff, 1988: 2; Howell, 1998: 3; Howell & Chaddick, 1994: 71; Kennedy, 1991: v; Sethi & Luther, 1986: 59; Simon, 1982: 68; Torre & Neckar, 1988: 222).

Political Events, Constraints and Discontinuities

A number of definitions point out that political risks are caused by political events, decisions, conditions and processes that impose constraints on foreign business enterprises or impact the investment climate in such a way that investors may lose money or suffer a reduced profit margin (Howell, 1998: 3; Bergner, 1982: 28; Fitzpatrick, 1983: 249; Howell & Chaddick, 1994: 71). Robock, for instance, defines political risk in terms of occurrences of a political nature, usually political events or constraints imposed on a specific industry or firm, that are difficult to anticipate (Akhter & Lusch, 1987: 81-101). Similarly, authors Brewer, Sethi, and Luther define political risk in terms of "uncertainty about the political environment of business and its effects on individual firms" (Brewer, 1985: 3; Sethi & Luther, 1986: 59).

Prast and Lax characterise political risk as a result of change in the political environment (Chermak, 1992; Akhter & Lusch, 1987: 82).

Governmental And Societal Action

A number of authors elaborate the term political risk by defining it in terms of discriminatory governmental action, policies or interference, including nationalisation, discriminatory taxation, regulatory controls, confiscation, remittance of profits, forced divestment or expropriation, that lead to negative and unwanted consequences including loss of control over ownership or assets without compensation, interference with the ongoing operations, or loss of benefits (Fitzpatrick, 1983: 249; Akhter & Lusch, 1987: 82; de la Torre & Neckar, 1988: 222; Czinkota, Ronkainen, Moffett & Moynihan, 1998: 238; Howell, 1986: 49).

Several authors add another dimension by describing political risk as actions undertaken by either a legitimate government, or actors beyond the direct control of governmental authorities, including labor unions, religious groups, ethnic minority groups, opposition forces, anti-globalization activist groups, or civil society movements, which negatively affect foreign business operations (Torre & Neckar, 1988: 222; Simon, 1982: 68; Czinkota, Ronkainen, Moffett & Moynihan, 1998: 238; Simon, 1984: 125; Howell & Chaddick, 1994: 71). Actions taken by these groups include war, revolution, terrorism, strikes, guerrilla warfare, extortion, threats and disruptions of operations, externally induced financial constraints, and externally imposed limits on imports or export (Czinkota, Ronkainen, Moffett & Moynihan, 1998: 238).

Non-market events

Some authors take a slightly wider perspective on political risk, and state that financial, strategic, or personal losses to the firms are caused by “events in the non-market environment of business” (Kennedy, 1991: v; Parker, 1998: 434). This perspective, thus, brings in not only political and social factors, but a number of other factors including economic, cultural, technological, psychological and environmental.

Risks and Opportunities

The above mentioned definitions consider risk in terms of “an eventuality of discontinuity” due to political reasons, and focus on sudden changes and uncertainty regarding the outcome of these events (Fitzpatrick, 1983: 250). They describe the causes and consequences of political risk, and the actors who are influenced by political events and instigators.

Most of these definitions highlight the fact that political risk leads to negative and unwanted consequences for a specific industry or an individual firm, including loss of control over ownership, loss of money or reduced profits. However, some authors point out that political risk analysis is not only about anticipating and avoiding political risks, but also about identifying opportunities and finding ways to turn high risks into high returns (Frei & Ruloff, 1988: 2; Howell, 1998: 60; Altier, 1999: 16; Brink, 2002). Not all risk is bad (Kloman, 2000: 1). Risk can be exploited and even profited from. As a matter of fact the greatest discoveries of the past centuries have been stimulated by the willingness of explorers, inventors, politicians and scientists to take chances of great loss in return for even greater potential gain (Kloman, 2000: 1).

In order to clearly understand the concept of political risk three further issues require some discussion. It is important to find out if there is a clear distinction between political risk and political instability. The relationship between political risk and country risk, as well as the relationship between macro and micro risk also need to be established. Furthermore, the levels of analysis in political risk, and the variety of environments in the political risk models need to be discussed.

2.5 Macro and Micro Risks

Many political risk authors make a distinction between the macro and micro risks (Fitzpatrick, 1983: 249-254; Kobrin, 1981:253). Macro risks are seen as unanticipated and politically motivated events and developments that are broadly directed at all foreign firms in a country (Fitzpatrick, 1983: 249-254; Frei & Ruloff, 1988: 3; Chicken, 1996: 122-123; de la Torre & Neckar, 1988: 222). Micro risks, on the other hand, are risks specific to an industry, a firm, a project, or even an individual (Fitzpatrick, 1983: 249-254; Frei & Ruloff, 1988: 3; Chicken, 1996: 122-123; de la Torre & Neckar, 1988: 222).

Most authors agree that the study of macro risk alone in many cases is not sufficient, and often misleading and impractical (Brewer, 1985: 340). The impact on firms' interest, indeed, takes place at the micro level of individual firms (Brewer, 1985: 340). The study of macro risk is useful as it provides background information, but the micro risk is what actually counts. Macro political risk analysis should always be complemented by an analysis of risks associated with the particular industry itself.

2.6 Political Instability and Political Risk

Despite some conflicting differences in definition, most authors of political risk agree that political risk and political instability are separate, although related phenomena (Fitzpatrick, 1983: 249-254). Political events and instability become political risks only when there is a reasonable possibility that a firm will suffer losses or perform worse than expected as a result of the instability (Kennedy, 1991: 2).

Political instability is often considered to be something negative. However, as many case studies have proved political instability may actually improve the business climate (Kobrin, 1978: 114). For example, some of the world's traditionally most stable countries (such as the Netherlands and Switzerland) are not necessarily as potentially profitable as countries of moderate or significant instability (such as the PRC and South Korea) (Bergner, 1982: 29). It is, therefore, also important to remember that assessments of instability in a given country should be specific about the form of instability, and the implications of the instability for a firm's interests (Brewer, 1985: 339, Kobrin, 1978: 114).

2.7 Country Risk and Political Risk

The term country risk is often incorrectly used interchangeably with the term political risk. However, there are some precise differences between these two terms. Country risk is a term that is generally used to describe the total risks, "non-business and business risks, that a country offers to foreign investors" (Frei & Ruloff, 1988: 3). It is also used by international bankers and credit rating agencies to describe financial risks, such as delayed or non-payment of debt, that are incurred in cross-border lending and investments (Kennedy, 1991: 1; Krayenbuehl, 1985). Political risk, on the other hand, is a term often used by foreign investors to describe adverse developments in the political, economic and socio-cultural environments (Kennedy, 1991: 2). However, it is often a component of country risk.

2.8 Levels of Analysis

There is a lack of consistency regarding the levels of analysis in political risk assessment. The majority of political risk assessment methods tend to include only the host country environment, and at the same time ignore a whole range of other environments that are important initiators of political risk, including the global, the international, the regional, the

home country, the industry, and the company (Austin, 1990: 30; Simon, 1984: 127; Brummestead, 1998: 86). However, in order to be able to provide scope to explain new or changing events and conditions in a rapidly changing global environment it is beneficial to take into account a wide spectrum of environments.

When a firm makes an entry to a foreign market, it enters more than just the host country's political, social, and economic environment (Simon, 1984: 125). The firm "becomes part of the international and global environments within which both the host and home countries must operate" (Simon, 1984: 125). In fact, as Jeffrey Simon from the Rand Corporation suggests there are four basic political environments in which every international firm must operate when investing abroad - host country, home country, international arena, and global arena (Simon, 1984: 123-142). In all these environments numerous political, social, and economic factors can affect the firm's performance, and with all these environments come certain types of political risks (Simon, 1984: 123-142). Thus, combining the risk indicators found in the host country environment and the risk indicators in the home country, international and global environments produces a better insight into the types of risks and opportunities firms are likely to face in the contemporary globalized world.

Let us take a closer look at these environments, starting with the global environment. In the global arena, the activities of the international organizations (the UN, the IMF, World Bank) including international economic sanctions, and multilateral trade agreements, and global developments such as worldwide recession, external debt crises, oil price fluctuations, energy crises, and terrorism are risk factors firms operating at the international level have to deal with (Simon, 1984: 123-142).

The international level, on the other hand, encompasses economic, political, cultural, and social interactions among countries through market transactions, multilateral mechanisms, bilateral linkages, and global industries (Austin, 1990: 32-35). Developments, events, and interactions among countries, commercial banks, development banks, trade organizations, international non-governmental organizations, regional organizations, civil societies, international activists, and multinational corporations also need to be taken into account when analysing the international environment as they influence the firm's operations (Doyle & Brown, 1998: 16; Simon, 1984: 127). Among the risks that may be expected in this environment are anti-globalisation demonstrations, terrorist attacks, negative international

public opinion, border conflicts, war, and detrimental trade agreements (Simon, 1984: 123-142).

The regional level revolves around regional conflicts, alignments, and political stability (Brummestead, 1998: 86). Political risks at the regional level include border disputes, territorial disputes, ethnic conflicts, wars, instable governments, to name a few.

The national (host country) level does not need much explaining as most political risk analyses use this level of analysis. The host country environment refers to actors, events and developments within in a country in which a firm has an investment, and involves the host government's strategy and policies, and societal actions and attitudes (Austin, 1990: 35; Simon, 1984: 126).

Home country environment refers to the actors and governmental, societal, legal and business developments within the country from which a firm is based (Simon, 1984: 123-142). The risks that a firm can face from the home environment among many others include restrictions on overseas operations and technology transfers, negative public opinion, protests, deterioration in relations between home government and host government (Simon, 1984: 123-142).

The industry level comprises a firm's competitive environment – its industry structure and competitive dynamics (Austin, 1990: 36; Goodstein, Nolan & Pfeiffer; 1993: 11; Micalizzi & Trigeorgis, 1999: 3). The risks in this environment arise from uncertainties surrounding quality, product differentiation, market supply, consumer taste, substitute goods, complementary goods, rivalry among competitors, new entrants, and technological changes (Miller, 1992: 317; de la Torre & Neckar, 1988: 235).

The company level includes the individual firm's strategy and operations (Austin, 1990: 38; Goodstein, Nolan & Pfeiffer; 1993: 11). The risks associated with the company level are to do with labour unrest, employee safety, raw material shortages, quality changes, machine failures, product liability, emission of pollutants, research and development activities, and corporate image (Miller, 1992: 317; de la Torre & Neckar, 1988: 235).

Many political risk authors agree that in order to construct a comprehensive picture of political risk all the above-mentioned levels of analysis should be considered. Yet, there is a

desire to keep political risk analyses simple. Political risk analyses that comprise all the levels of analysis tend to be too complex. Thus, it is essential that one of the levels of analysis is dominant and other levels are considered, but not directly (Brummestead, 1998: 88)

2.9 The Key Environmental Forces

One of the primary tasks in political risk analysis is to identify, analyse, and manage what political risk analysts refer to as either environmental forces or factors that impact the organization or the investment. (Austin, 1990: 30; Simon, 1984: 123).

Some political risk assessment methods simply consider the political forces at work, including political stability, ideology, institutions, and international links (Austin, 1990: 31; Brummestead, 1998: 90). They look at indicators of political nature, such as war, revolution, changes in government, political turmoil, leadership struggle, and government policies such as fiscal and monetary reforms, price controls, discriminatory taxes, trade restrictions, nationalisation, and inadequate provision of public services (Miller, 1992: 314; Simon, 1984: 128-129).

There are a large number of political risk methods that take into consideration, not only political, but also economic and social factors affecting the business environment (Simon, 1984: 123). The economic factors consist of natural resources, labour, capital, infrastructure, and technology (Austin, 1990: 31). Inflation, changes in relative prices, foreign exchange rates, interest rates, and terms of trade are some of the factors frequently used to measure economic risk (Miller, 1992: 314; Simon, 1984: 128-129). The social factors, on the other hand, involve factors such as values, attitudes, population growth, age structure, urbanization, migration, and health status (Austin, 1990: 31; Byars, 1991: 44; Williams, Smith & Young, 1998: 67). The most frequently used indicators of social uncertainties include social unrest, riots, demonstrations, and terrorist activities to name a few (Simon, 1984: 128-129).

There are several risk assessment methods that include cultural (social structure and dynamics, religion, human nature, gender roles and language), technological (new ideas, developments, and inventions), environmental (natural phenomena such as abnormal weather patterns and natural disasters like as hurricanes, earthquakes, droughts, and floods are all indicators of environmental uncertainties), and psychological (traits, beliefs, attitudes, perceptions, past experiences, social background of relevant political decision-makers)

driving forces (Miller, 1992: 314; Austin, 1990: 30; Byars, 1991: 43; Brummestead, 1998: 89). Some political risk analysts support their use, as they believe they can provide more comprehensive, and reliable risk assessments. However, others argue that the objective of political risk analysis is to analyse risks of a political nature, not all possible risks.

It is, nevertheless, almost impossible to separate different categories of environmental forces from one another, as they are all interlinked to one another. (An ethnic war, for instance, has an immediate impact on social, economic, cultural, environmental, psychological, and even technological forces shaping the country.) They also argue that it is essential to incorporate all forms of environmental factors in one way or another, even when the main focus is on political factors.

2.10 Methods of Analysing Political Risk

Much has been written with regard to the methodology of political risk analysis. However, no integrated framework exists that can guide political risk analysts (de la Torre & Neckar, 1988: 227). The differences in opinion and contradictions found in the research material indicate that there is no simple right or wrong political risk analysis approach or model.

There are a number of methodologies available for political risk analysis, ranging from informal, unsystematic assessments by a few individuals to formal, systematic, and sophisticated risk analysis models (Mascarenhas & Atherton, 1982: 22; Nelson, 1999: 26).

Grand Tours and Old Hands Techniques

Approaches such as 'grand tours', 'old hands', and Delphi technique are well-known country expert generated opinion analyses (Chermak, 1992: 173; Simon, 1985: 137). In the 'grand tours' and 'old hands' techniques the ultimate decision to invest or disinvest usually lies with only a few people, namely top executives (Simon, 1985: 137). The decision is based on the decision-makers' impressions, stereotypes, opinions, and perceptions of the foreign country (Simon, 1985: 137). In the 'grand tours' approach the knowledge of the country is usually obtained by the top management on their visit to the country (Chermak, 1992: 173). 'Old hands' approach incorporates the opinions of people with long experience in the country (Chermak, 1992: 173; Nelson, 1999: 26). Both approaches are based mostly on subjective, selective, and biased evaluations (Chermak, 1992: 173; Frei & Ruloff, 1988: 6).

The Delphi Methods

The Delphi method is another technique that depends heavily on an expert's opinion. However, in this approach bias and subjectivity are lessened by soliciting opinions, through a structured interview system, from a group of experts, often around the world (Chermak, 1992: 173; Torre & Neckar, 1988: 228; Byars, 1991: 47; Granger, 1989: 216). The opinions are combined in a systematic way, resulting in an index, "composed of a variety of weighted variables that is an additive sum (of risk) for the country as a whole and for any type of foreign investment" (Howell, 1998: 5).

Among the best known and most used expert generated models are the business environmental risk index (BERI), the business international (BI) system, Institutional Investor, International Country Risk Guide (ICRG), and the world political risk forecasts (WPRF) (Chermak, 1992: 173; Frei & Ruloff, 1988: 7; de la Torre & Neckar, 1988: 228). All these above-mentioned models comparatively rank a large number of countries and produce detailed forecast reports.

The major problem with Delphi models is that the analyses are ultimately based on the judgments of the experts and observers (Torre & Neckar, 1988: 228). In addition, they are macro-risk oriented and largely ignore the project-specific risks (Torre & Neckar, 1988: 228).

In-House Models

Many large international corporations, such as General Motors (GM), Shell Oil Company, and the Bank of America, generate their own risk analysis profiles of countries (Chermak, 1992: 175). These types of risk assessment models are specifically tailored to the needs of the corporations. For instance, Shell Oil's political risk models were developed to "assess the probability that contracts for the exploration, development and production of oil in a certain country will be maintained on an equitable basis for a period of up to ten years" (Torre & Neckar, 1988: 229).

The biggest limitation for in-house models is the cost issue (Torre & Neckar, 1988: 229). Expertise needed to conduct a political risk assessment, and as well as collecting, processing and analyzing data on a global basis is extremely costly and time-consuming (Torre & Neckar, 1988: 229).

Econometric Models

Most organizations that conduct political risk analysis or country risk analysis, including the PSSI, use systematic, mathematical methods of forecasting political and country risk. The objective of econometric models is that the final index is free of judgmental distortions (Torre & Neckar, 1988: 228). The econometric models rely on econometric and other objective data, such as estimates of gross domestic product (GDP), population dynamics, literacy rate, and violent or frequent regime changes, obtained from the political, economic and socio-cultural environments (Torre & Neckar, 1988: 228; Kobrin, 1981: 256). However, there is no guarantee that these types of models are objective. The structure and the variables used in the models do not necessarily represent the reality accurately (Torre & Neckar, 1988: 228). The problems inherent in systematic political risk models are that they are macro-risk oriented and largely ignore the project-specific risks (Torre & Neckar, 1988: 228).

2.11 Debate on Quantitative and Qualitative Approaches

Many believe that the greatest potential for obtaining accurate and objective risk forecasts lies in the development of complex, quantitative models (Schnaars, 1987: 105). Some political risk analysts take a quantitative approach and argue that the so-called 'soft' political, social and environmental indicators may be empirically observed, measured, and represented in quantitative models alongside 'hard' indicators (Brink, 2002).

The critics of quantitative methods, on the other hand, stress that there is no pressing need to develop quantitative political risk models as they are no more accurate than much more simplistic qualitative approaches (Schnaars, 1987: 105, Rayfield, 1988: 174; Parker, 1998: 434). To understand both viewpoints it is important to take a look at the debate.

In quantitative research, the researcher is ideally an objective observer who does not influence what is being studied, but relies on highly sophisticated numerical methods and 'hard data' in the research (Simon, 1985: 143; EssayBank.Co.UK, 2002: 1). As a result, a quantitative researcher is believed to be more objective than a qualitative researcher who is more immersed in what is being studied and subject to his or her own judgment, rationality and logic.

Besides objectivity, quantitative research has a number of advantages that appeal to many political risk analysts. Quantitative methods allow for generalisations, replications and

comparisons of countries with respect to economic factors and basic political and social factors (Simon, 1985: 143; Lancaster, 2002: 1; EssayBank.Co.UK, 2002: 1).

As the literature reviewed in this chapter has demonstrated, the majority of political risk assessment models incline towards quantitative methods of research, although, qualitative methods are also widely used in conjunction with quantitative methods.

Several academic research papers on political risk analysis support the use of quantitative methods and quantification of soft political variables. For instance, a comparative study by Somerville and Taffler on the judgemental accuracy of bankers and the performance of formal statistical models, in the context of country risk assessment and forecasting, showed that bankers' judgements were biased towards the creditworthiness of Least Developed Countries (LDSs), and that statistical models had a better overall predictive success rate (1995: 294). Furthermore, a study by Erb, Harvey and Viskanta found that the financial risk indicators (quantitative) contain the most information about future expected returns and that political risk (qualitative) contains the least (1996: 29).

Quantitative approaches, however, have some drawbacks. Firstly, there are many factors (power, influence, conflict, consensus, etc.) in political risk research that are difficult if not impossible to quantify or measure statistically, and thus merging them into quantitative systems and models in a systematic manner is a complex process (Doyle & Brown, 1998: 13; Brewer, 1985: 345; Brummestead, 1998: 81; Rayfield, 1988: 174).

Secondly, quantitative risk models tend to focus primarily on economic conditions (hard data), and give secondary treatment to non-market factors, namely political and social factors, thus failing to account for many substantive factors (Simon, 1985: 144; Brummestead, 1998: 81). The picture presented by quantitative methods is also less rich or detailed (EssayBank.Co.UK, 2002: 1).

Quantitative risk models also tend to be more inclined towards macro risk assessment (country risk), and are less often used for industry-specific or company-specific situations (Simon, 1985: 144). In addition, quantitative research is criticised for giving narrow, unrealistic information using measures, which capture only a tiny proportion of the concept originally under study (EssayBank.Co.UK, 2002: 1).

Advocates of qualitative research argue that a researcher that is participating or immersed in what is being studied can either learn the most about the situation or utilize his or her expert knowledge on the subject (Simon, 1985: 144). Additionally, qualitative research is less structured, more flexible, holistic and inclusive than the quantitative approach (Babbie & Mouton: 2001: 77). Qualitative research is open in that it may generate new theories and recognize phenomena ignored by previous researchers and literature. It helps researchers to simulate their experience of the world and perceive different points of view, to gain an understanding of underlying reasons and motivations, to provide insights into the setting of a problem, and to uncover prevalent trends in thought and opinion (Mercator, 2002: 1). Qualitative research in general attempts to capture the world without pre-judgments and get more depth and detail than standardized quantitative approaches.

In the field of political risk analysis, there is also no evidence that quantitative political risk models are more accurate than much more simplistic approaches (Schnaars, 1987: 105, Rayfield, 1988: 174; Parker, 1998: 434). As Stephen J. Kobrin states “effective political assessment is more likely to result from explicit specification of causal relationships and implementation of systematic analytical procedures than from development of increased methodological sophistication or elegance” (1981: 251). In addition, the father of scenario planning, Herman Kahn has stated that when all of the clever mathematical manipulations are stripped away, model building “comes down to a simplistic intuition or an expression of bias rather than a careful synthesis and balancing of the analysis with more subtle qualitative considerations” (Schnaars, 1987: 160).

Qualitative research has its weaknesses, however. The results of qualitative research are less easily generalised or replicated, as well as aggregating data and making systematic comparisons are difficult (Lancaster, 2002: 1; EssayBank.Co.UK, 2002: 1; Chappell, 2002: 1).

Qualitative research is also dependent upon a researcher’s personal attributes, opinions, judgments, and skills, and thus analysis is more subjective (Byars, 1991: 47; Simon, 1985: 144; EssayBank.Co.UK, 2002: 1; Chappell, 2002: 1).

Many political risk analysts agree that what is needed is a better understanding of political events, processes, and their effects (Kennedy, 1991: 21 & Kobrin, 1978: 121). Additionally, greater accuracy in forecasting can be achieved by spending more time and effort collecting

relevant, updated, and accurate information on a continuous basis (Marks, 1988: 187 & Bergner, 1982: 30). Many authors suggest that the best approach is to combine both quantitative and qualitative methods in political risk analysis (Kloman, Apr. 1998: 1).

2.12 Advantages and Disadvantages of Political Risk Analysis

There are a number of problems political risk analysts encounter in their field of study.

Firstly, the relevant and systematically collected data are limited (Kobrin, 1981: 254; Mascarenhas & Atherton, 1982: 25; Chicken, 1996: 34; de la Torre & Neckar, 1988: 224; Kloman, 1997). Knowledge of the political processes and events, country-specific expertise, and specific industry data are not always easily available (Kobrin, 1981: 255). Also, information available may be distorted, erroneous, unreliable or manipulated (Mascarenhas & Atherton, 1982: 26; de la Torre & Neckar, 1988: 224; Howell, 1986: 70).

Inconsistencies and inaccuracies arise for many reasons, including incompetence, poor reporting, and suspect manipulation of data (Mascarenhas & Atherton, 1982: 26; Howell, 1998: 297; Torre & Neckar, 1988: 224). Such problems are traditionally attributed to the countries of Latin America, Africa, the Middle East, Asia, and Eastern Europe, who certainly present a range of difficulties for obtaining reliable data (Howell, 1998: 297; Austin, 1990: 55). However, recent controversies have shown that even industrialized nations struggle with the same problems. The recent accounting scandals in the United States (US) are a good example.

Secondly, as since political risk assessment methods include a vast variety of political, economic and social factors, merging all the relevant factors into one risk assessment model is a complex exercise, and holds the possibility of being unable to produce the desired results (Kobrin, 1981: 254).

Thirdly, in most political risk analysis models the level of analysis is the host country (Kobrin, 1981: 254). However, as shown earlier in this study, there are a number of other levels, including global, international, regional, industry and company that cannot be completely ignored.

The time-consuming nature of political risk assessments implies that the final report may be out-dated by the time it is completed (Mascarenhas & Atherton, 1982: 24). In addition,

political risk analyses tend to be reactive rather than proactive (Mascarenhas & Atherton, 1982: 25; Fitzpatrick, 1983: 253). In other words, many times risk analyses often fail to anticipate future developments.

Political risk assessments are often biased for the simple reason that organizations tend to be consistent with their own objectives, interests, and points of view (Howell, 1998: 295; Reisen, 1998: 1; Economist, 1997: 1). If a financial institution, for instance, holds a substantial stake in the country it is inclined to be excessively optimistic in their forecasts (Howell, 1998: 295). By contrast, insurance companies, concerned with risk and loss, tend to be overly pessimistic (Howell, 1998: 295). In addition, there is a tendency to view political risk and investment risk as a problems of developing or emerging economies (Brink, 2002). Too much attention is paid to issues such as expropriations, confiscations, exchange controls and government instability (Brink, 2002).

Highly quantitative models of risk assessment are problematic because they are often based on the same political, economic and social indicators, usually obtained from the same, common sources (Doyle & Brown, 1998: 12). This often results in a high degree of correlation between the assessments, and reinforces the so called 'herd instinct' (Doyle & Brown, 1998: 12). One of the most recent incidents of 'herd instinct' is the failure of risk rating agencies to predict the Asian economic crisis (Luce, 1998: 1; Reisen, 1998: 1; Summit Analytical Associates, 2002: 1). Prior to the crisis, as the risk rating agencies failed to foresee the looming problems, they continued to give high ratings to the Asian countries (Reisen, 1998: 1). However, suddenly after the crisis started they overreacted by dramatically downgrading the country ratings (Reisen, 1998: 1).

2.13 Summary

As the critical overview of the prescribed literature demonstrates a consensus on the defining meaning of political risk analysis has not yet been reached. Additionally, the methods of conducting political risk assessment are numerous – no systematic method exists.

There are several other important conclusions to be drawn from political risk literature:

- The concepts of macro and micro environment are interrelated. The latter is a more vital aspect of the political risk. Even though the environment of a particular country

may appear to be conducive for investment, the micro risk will determine the direction of the business and this is what is important in the analysis.

- Instability is not necessarily a negative factor in international business. It may encourage countries to introduce structural reforms that will encourage investors, and improve a country's economy.
- Country-risk may be regarded as a useful and complementary tool in political risk assessment.
- Political risk analysis cannot completely ignore other non-market forces (economic, social, cultural, technological, environmental, and even psychological) affecting the business environment.
- Although the main level of analysis in political risk studies is the host country environment, ignoring for various other environments (home country, international, regional, global, industry, and company) will result in incomplete and inadequate analyses.

Keeping these lessons in mind the third chapter will introduce the scenario-planning method in great detail and the six steps that will be later used in the political risk case study on the PRC.

CHAPTER 3

Scenario Planning Method

3.1 Introduction to Scenario-Planning

As this chapter will demonstrate the scenario-planning method as a forecasting tool provides insightful information necessary to understand, anticipate, and respond to change and uncertainty in an increasingly global world environment. Although the future cannot be forecast or predicted with certainty, the very process of thinking about the future and exploring the implications of alternative futures may have a profound impact on foreign investment. This chapter will also introduce the six steps of scenario planning that will be later applied to the case study on political risks in the PRC in the last chapter.

Scenario-planning first emerged after the Second World War as a method for military and strategic planning for the United States (US) government (Wright, 2000: 1; Fahey & Randall, 1998: 17; Spies, 1982: 5; Schwartz, 1999: 7; van der Heijden, 1996: 15; Kenter, 1998: 1). It moved to the civil domain through the Rand Corporation, and was further developed by Herman Kahn during his tenure at the institute (van der Heijden, 1996: 15; Kenter, 1998: 1: 1).

Shell was the first organisation to use and apply scenarios in a corporate setting (Fahey & Randall, 1998: 17; Wright, 2000: 1; Kenter, 1998: 1: 1; Davis-Floyd, 1996; Fein, 2002: 1; Kleiner, 1999). It all started in the early 1970's when Pierre Wack and other planners at Shell were looking for events that might affect the oil price dramatically (Kenter, 1998: 1: 1; Wack, 1985: 80, Ringland, 1998: 20). By constructing different future scenarios based on trends at the time they realised that a more unstable environment was to be expected with a shift of power from oil companies to oil producers (Epstein, 1998; Schwartz, 1999: 7; Wilson, 1998: 353; van der Heijden, 1996: 16; Kenter, 1998: 1; Wack, 1985: 80, 141; Ringland, 1998: 20). As a result of their projected future scenarios, Shell was able to take precautionary actions and be better positioned than most oil companies when the 1973 embargo of oil struck, resulting in a sharp increase in crude oil prices, shortage in the supplies of gasoline to the consumer, explosive inflation, and a depressing impact on the world economy (Epstein, 1998; Wilson, 1998: 353; Kenter, 1998: 1; College of Marin, 2002: 1; Wack, 1985: 88; Ringland, 1998: 20). Similarly, in the beginning of 1986 when the crude oil price dropped dramatically, Shell was

ready to react as a result of the scenarios developed several years earlier which predicted the plummeting of the oil price (Altier, 1999: 182; De Geus, 1988: 72-73).

Today, scenario planning is regularly used as a part of the organizational learning process, strategic decision-making or management approach (Business Futures, 1997: 25; Ingram, 1993; Schoemaker, 1993: 193-213; van der Heijden; Kenter, 1998: 1; MetaBridge, 1996: 1; Bain & Company, 2002: 1; De Geus, 1988: 71). In the United States, approximately 20 percent of corporations have used scenario planning at some stage. Companies and organizations in both private and public sector use the scenario approach to identify possible business opportunities and threats; to anticipate and prepare for change and uncertainty; to conduct long-range planning and forecasting; to enhance critical thinking and organisational learning; to test and refine their strategies; to challenge assumptions decision-makers have about the future; to augment understanding; and to create new options for decision-making (Fahey & Randall, 1998: 4; van der Heijden, 1998: 335; Bonnett & Olson, 1998: 309; Wright, 2000: 1; Coles, 2000: 1; Fahey & Randall, 1998: 3, 12; Marsh, 1998: 39; Wilson, 1998: 81; Perrottet, 1998: 123; Fahey, 1998: 191; Swartz, 1999: 9; Brundle, 2002: 1; Kenter, 1998: 1; Ashley & Morrison: 1996: 35-50; Fein, 2002: 1; van der Heijden, 1997: 1; Bures, 2002: 1; GBN, 2002: 1; Wack, 1985: 74; De Geus, 1988: 71; Bood & Postma, 1997: 636). The scenario approach is also a familiar forecasting method in the field of political risk analysis, and several risk-rating agencies, in fact, use the scenario planning method to conduct political risk assessment (Howell, 1998).

3.2 How Scenario planning Differs from Other Forecasting Methods

Scenario planning differs from most other approaches to forecasting in two ways (Schnaars, 1987: 154). To begin with, the objective of scenario planning is to provide qualitative and contextual descriptions of possible future developments, rather than to seek numerical precision (Schnaars, 1987: 154; Wilson, 1998: 353). Although there are some quantitative methods of generating scenarios, such as cross-impact analysis, and computer-driven BASICS (Battelle Scenario Inputs to Corporate Strategy), CSM (Comprehensive Situation Mapping) and MARKSTRAT, scenario planning in general is a qualitative method (Schnaars, 1987: 159; Spies, 1982: 6; Wilson, 1998: 353; Ringland, 1998: 193-208).

Secondly, the scenario planning method does not try to accurately predict what will happen in the future or to provide the right tool for foreseeing the future developments, but to offer a

range of possible futures, each of whose occurrence is plausible, but not assured (Schnaars, 1987: 154; Business Futures, 1997: 25; Swartz, 1999: 6, Wright, 2000: 1, Coles, 2000: 1; Fahey & Randall, 1998: 4; Challenge Forum, 2001: 1; Epstein, 1998; South Wind Design, 2001: 1; Kairos Future; 2002: 1, Kenter, 1998: 1; Ashley & Morrison, 1996: 1996: 35-50; Fein, 2002: 1; Kleiner, 1999: 1; Wilkinson, 2002: 1; NATO, 2002: 1; College of Marin, 2002: 1; Finland Futures Research Centre, 2001: 1; Granger, 1989: 224; Wack, 1985: 146).

3.3 Definition of Scenario

The term scenario has many meanings. The Oxford Dictionary defines a scenario as a suggested sequence or development of events (2001: 1152). Similarly, Kahn and Wiener in Schnaars (1987: 155), pioneers of the scenario planning approach, characterise a scenario as a hypothetical sequence of events constructed for the purpose of focusing attention on causal processes and decision points.

Schoemaker summarises scenarios as descriptions of fundamentally different futures presented in coherent script-like and narrative fashion (1993: 195). Clem Sunter and Chantell Illbury, on the other hand, describe scenarios as multiple pathways into the unknown future (2001: 41 & 87).

Peter Schwartz identifies scenarios as stories about the way the world might turn out tomorrow (1996: 2-3). In the same way, Michael Porter defines a scenario as “an internally consistent view of what the future might turn out to be – not a forecast, but one possible future outcome” (Epstein, 1998).

In general, scenario planning is a technique which “attempts to set up a logical sequence of events in order to show how, starting from the present, or any given situation, a future state may evolve step by step” (Tydeman & Mitchell in Spies, 1982: 12).

In simple terms, the scenario is a written analysis in the form of a narrative or a story that helps decision-makers to identify 1) the key political, economic, social, and other (such as technological, cultural, environmental, psychological) driving forces which require monitoring in their specific project; 2) potential political, economic and social scenarios and outlooks for the future over a predetermined period of time; and 3) likely risks and opportunities under each scenario which can be incorporated into day-to-day strategic and

operational planning and management (Oxford Analytica, 1997: 1; Linneman & Kennell, 1977: 141, Schwartz, 1996: 2-3; Wright, 2000: 1; van der Heijden, 1996: 2; Wack, 1985: 139).

3.4 Advantages and Disadvantages of Scenario-Planning Method

The scenario-planning method has a great number of advantages. First of all, scenarios help decision-makers to confront the unfavorable turn of events with confidence and calmness, anticipate and understand risk, and face the challenges by being aware of the possible pathways and strategic options to the future (Fahey & Randall, 1998: 3; Wack, 1985: 146).

Some scenario planners believe that the greatest potential for the use of scenario planning in forecasting lies within narrow focus – namely at the industry or project level (Schnaars, 1987: 156; Morrison & Wilson, 1997: 1). Scenario planning is also best suited for longer time horizons since over longer time spans the accuracy of most forecast models deteriorates (Schnaars, 1987: 165; Morrison & Wilson, 1997: 1).

Scenario planning also has the advantage over other methods when uncertainty is high, and historical relationships are shaky (Schnaars, 1987: 165; Business Futures, 1997: 26; Morrison & Wilson, 1997: 1; van der Heijden, 1997: 1). In such instances, traditional forecasting models, such as time-series and econometric models, are likely to perform inadequately since their focus is on historical data and patterns of relationships (Schnaars, 1987: 165).

Scenario planning is also believed to be beneficial as it contributes to “stimulating strategic thought and communication within companies ... and improving internal flexibility of response to environmental uncertainty” (Business Futures, 1997: 26). Furthermore, scenarios give decision-makers the best possible leverage in advance to deal with a wide range of potential future developments and outcomes, and to consider possible responses and ways of reacting to anticipated risks (Ilbury and Sunter, 2001: 42; Courtney, Kirkland, & Viguerie, 1999: 9; Joyce & Woods, 2001: 190; Ringland, 1998). In other words, scenarios help decision-makers to recognize, consider and reflect upon the uncertainties they might face in the future, and to envision challenging alternative futures (Wright, 2000: 1; Coles, 2001: 1; van der Heijden, 1996: 5; Kleiner, 1999).

Scenario planning method has the advantage of being highly flexible. It can be easily adapted to the needs of the specific situation. Scenario planning, indeed, uses a specific decision or issue as a focus or starting point for the whole process (Ringland, 1998: 247).

Even though scenario planning is a qualitative method, it has the power to utilise both logic and imagination to create images of the future (Ringland, 1998: 248). According to Ringland the two aspects of successful models are their ability to anticipate real world behavior logically, and to create mental models "which allow the user to look for early confirming or disconfirming evidence" (1998: 10). In the case of scenario planning these two criteria are fulfilled. Scenario planning is good at anticipating future events and developments. It is also a continuous process, designed to be alert for warning signals in the environment.

The fact that scenarios are written as a narrative is advantageous for three reasons compared with traditional methods of communication, which rely on tables, graphs and numbers (Wright, 2000: 1; Schwartz, 1998). Firstly, scenarios provide a context for information, enabling a reader to gain useful meaning and understanding (Wright, 2000: 1). Secondly, scenarios help decision-makers to identify with stories because they represent real-life situations and give a more all-round explanation of why things happen in a certain way, thus, yielding context and meaning (Coles, 2000: 1; Kenter, 1998: 1; GBN, 2002: 1). And lastly, scenarios allow decision-makers to admit that they do not know with certainty what the future will turn out to be, but nevertheless they help them to plan for multiple futures (Ringland, 1998: 190).

One of the major disadvantages of scenario development is that it is time-consuming, lasting on average from six months to a year (Kleiner, 1999: 1; NATO, 2002: 1; Ringland, 1998: 34). Pierre Wack's group at Shell, for instance, spent almost a year to develop their first scenarios (Kleiner, 1999: 1). The second disadvantage is the reality that scenarios are developed by people, and thus they are to a greater or lesser extent subjective (NATO, 2002: 1).

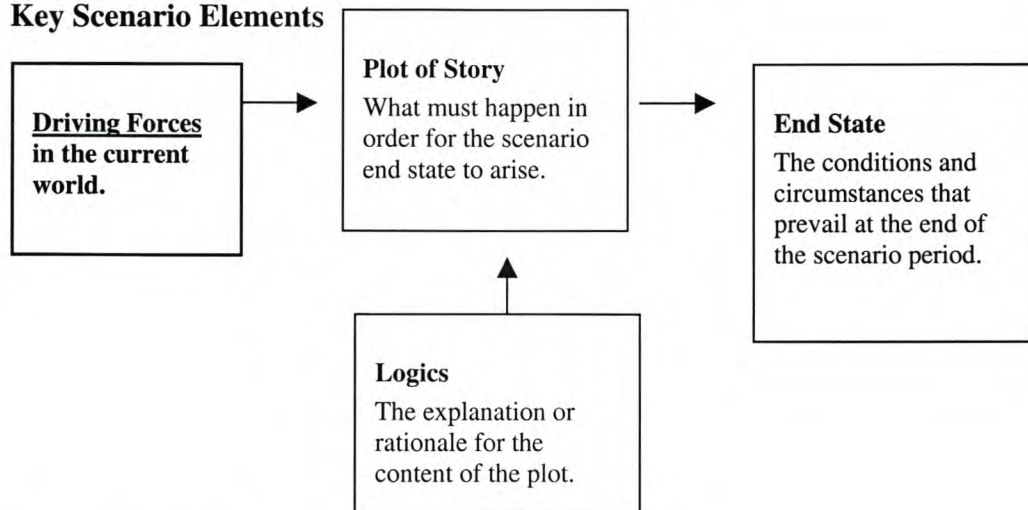
Scenario planning in the corporate setting has also failed numerous times due to an oversimplistic use of the technique, the confusion between forecasts and scenarios, and the lack of strategic integration into the company's concerns and decisions (Ringland, 1998: 23, 34). Scenario development has often been regarded as one time exercise of long-term planning rather than a continuous process (Ringland, 1998: 35).

3.5 The Elements of Scenarios

Scenarios have four key elements: driving forces, logics, plots, and end states (Fahey & Randall, 1998: 10).

Graph 1.

Key Scenario Elements



Source: Fahey & Randall, 1998: 10

Driving forces are forces that shape, drive and determine the story of the future described in a particular plot (Fahey & Randall, 1998: 10; Schwartz, 1999: 101; South Wind Design, 2001). These forces fall roughly into two categories: macro environmental forces, and micro environmental forces (or the actions of institutions as defined by Fahey and Randall) (Fahey & Randall, 1998: 10; Morrison & Wilson, 1997; Wilkinson; 2002: 1). Macro environmental forces are economic, social, political, cultural, and technological events, actions, trends, and developments that can affect a particular organisation directly or indirectly (Fahey & Randall, 1998: 10; Schwartz, 1999: 105; South Wind Design, 2001; Morrison & Wilson, 1997: 1). The actions of institutions, on the other hand, include business organisations, political parties, governmental agencies, societal movements, non-governmental bodies, and regional and international organisations (Fahey & Randall, 1998: 10). It is the interaction of all these forces that creates complex and interesting plots (Schwartz & Ogilvy, 1998: 60). Many of the driving forces also have counter-forces (Kleiner, 1999: 1). For instance, if web sites with high sex content proliferate, the forces of "parental concern" and "moralistic outrage" will grow stronger (Kleiner, 1999: 1).

Some of the driving forces are predetermined and others are highly uncertain (Schwartz, 1999: 242; Kania, 1998: 268; South Wind Design, 2001: 1; Kenter, 1998: 1; Wack, 1985: 140). Predetermined events are those that are certain or nearly certain to evolve or persist under any scenario based on previous events and developments (Kania, 1998: 268; Kleiner, 1999: 1; Wilkinson, 2002: 1; MetaBridge, 1996: 1; Ingram, 1993; Wack, 1985: 140). Critical uncertainties, on the other hand, are events and developments that will have consequences that cannot yet be measured and are focal to the key issues and decision in the scenarios (Kania, 1998: 268; Wilkinson, 2002; Frieswick, 2002: 1; Ingram, 1993).

Most traditional scenario methods use predetermined events as “a common platform and then create possible future worlds around different combinations of critical uncertainties” (Kania, 1998: 268). The predetermined elements are unlikely to vary in any of the scenarios, whereas uncertainties are most likely to change the nature of direction of the scenarios (Schwartz & Ogilvy, 1998: 61).

Logics consist of the rationales and explanations for the content of the plot (Fahey & Randall, 1998: 10). Logics answer the why, what and how questions, help decision-makers to assess the plausibility of a scenario and to tie together the elements of scenarios (Fahey & Randall, 1998: 11; Fahey, 1998: 209; Kenter, 1998: 1).

Plots illustrate what must take place in order for the scenario end state to arise (Fahey & Randall, 1998: 11). Each plot contains a story that connects the present to the end state (Fahey & Randall, 1998: 11). Each plot should be convincing, believable, well constructed, unique, and “flawlessly rational” with an element of surprise (Schwartz & Ogilvy, 1998: 57; Kleiner, 1999: 1; NATO, 2002: 1).

There are a few specific plots that frequently show up in the scenario literature. First one of these scenarios is called ‘winners and losers’. In this type of scenario conflict is inevitable due to the lack of resources, and as a result winners and losers emerge (Swartz, 1999: 141; Swartz & Ogilvy, 1998: 71; Fahey, 1998: 218; South Wind Design, 2001: 1; Kenter, 1998: 1; Kleiner, 1999: 1). The second plot ‘Challenge and Response’ starts with a perception that every challenge has a response (Swartz, 1999: 145; Swartz & Ogilvy, 1998: 71; South Wind Design, 2001: 1; Kenter, 1998: 1; Kleiner, 1999: 1). There might be winners and losers, but in the long run both winners and losers learn to adapt until the next challenge (Swartz, 1999: 145; Swartz & Ogilvy, 1998: 72; Kenter, 1998: 1). Evolution is the third plot frequently used

by scenario analysts (Swartz, 1999: 147; Swartz & Ogilvy, 1998: 73; South Wind Design, 2001; Kenter, 1998: 1). It is based on the premise that changes are evolutionary in nature, thus growth and decline in all systems occur slowly and unnoticed (Swartz, 1999: 148; Swartz & Ogilvy, 1998: 73; Kenter, 1998: 1). There are a number of other rather common plots, including Revolution (abrupt discontinuities), Cycles (cyclical nature of driving forces), Infinite Possibility (continuous growth is possible), and the Lone Ranger (an organisation or a main character fights against the established powers), that have also been used by scenario analysts (Swartz, 1999: 151-156; Swartz & Ogilvy, 1998: 73; South Wind Design, 2001: 1; Kenter, 1998: 1).

The end state describes the conditions and circumstances that prevail at the end of the scenario period (Fahey & Randall, 1998: 11; Fahey, 1998: 203; Wilson & Randall, 1998: 372). The end state is not an accurate prediction of tomorrow, but a speculative projection of the future (Schwartz, 1999: 9)

3.6 Multiple Types of Scenarios

There exists no universally accepted method for constructing scenarios as scenarios are usually developed for a specific purpose (Spies, 1982: 15; Swartz & Ogilvy, 1998: 67; van der Heijden, 1997: 1). However, three most frequently used scenario-planning methods are called inductive, deductive and incremental (van der Heijden, 1996: 196).

The deductive approach considers a large number of factors, but either set the dominant structures or background themes of scenarios beforehand or integrate these factors into a consistent set of scenarios later on (Schnaars, 1987: 162; NATO, 2002: 1). The approach begins with the identification of several significant futures or end states, which is followed by the development of stories or plots to show what would have to happen for each end state to emerge from the present (Fahey & Randall, 1998: 19; Ringland, 1998: 235). Deductive method is, then, a more codified, time-efficient step-by-step approach (van der Heijden, 1996: 212).

In the inductive method, on the other hand, the range of plausible futures is based on an analysis of a few key forces and trends and their likely developments and processes (Fahey & Randall, 1998: 19; Schnaars, 1987: 212; NATO, 2002: 1). Storylines in scenarios are built step by step on the data available (van der Heijden, 1996: 198). The inductive approach has

two basic variants. One identifies significant future events, and then creates larger stories around them. The other first drafts the “official future” – “an unsurprising and relatively non-threatening scenario”, and then explores influences and driving forces that could produce unexpected outcomes or to cause “the actual future to deviate substantially from that path” (Schwartz & Ogilvy, 1998: 62 & 63).

The third and the last method - the incremental approach uses a shared official future forecast as the starting point, from which the scenarios emerge (van der Heijden, 1996: 196 & 202). In incremental approach, the construction of scenarios begins with the identification of end-states (Wright, 2000: 1). The second step in a process comprises the identification of events that need to occur for each end-state to be realised (Wright, 2000: 1). Lastly, a detailed study of the events, their probability, their internal consistency and their relationship with the end-state is conducted (Wright, 2000: 1). The incremental approach is useful in a situation in which the organization is not completely convinced that the scenario method offers an improvement over the traditional forecasting method and is strongly attached to an “official” shared future (van der Heijden, 1996: 196).

All three approaches have their disadvantages. The deductive approach risks the elimination of a key scenario, the inductive the omission of a key variable, and the incremental method is less creative than the other approaches (Schnaars, 1987: 162).

3.7 The Number of Scenarios Used in Scenario-Planning

Another issue important and much debated in scenario planning is the number of scenarios. Strategic planning that takes place in organizations is often limited to the premise identified in ‘scenario one’, which describes that the future world will largely be the same as today only a little bit better (Wright, 2000: 1; MetaBridge, 1996: 1). Most managers and decision-makers feel the most comfortable with this view, as they would not want to wish that the future of their organization is worse than today (Wright, 2000: 1). However, as today’s world is characterized by uncertainty and instability, the future described in scenario one is becoming more and more unlikely (Wright, 2000: 1).

Most authors agree that two to four scenarios are usually sufficient to provide the range of future outcomes (Schoemaker, 1998: 425; Wright, 2000: 1; van der Heijden, 1996: 187;

Flower, 1997: 1; Wack, 1985: 146). To draft more than four scenarios that are merely slight variations on a theme is not advisable (Swartz & Ogilvy, 1998: 78; Schoemaker, 1998: 425).

Some authors argue that developing more than three scenarios tends to be complex, confusing and may hinder decision-making (Rossiter, Karplus, & Jones, 1986: 136). However, there is a danger in developing only three scenarios, mainly that the middle scenario is seen as the most-likely-case and the other two are rejected as the two extremes (the worst case and the best case), in which case the objective of constructing the scenarios is lost (Business Futures, 1997: 26; Swartz & Ogilvy, 1998: 77; Wack, 1985: 146; Ringland, 1998: 80; Joyce & Woods, 2001: 188).

3.8 The Process of Scenario planning

In the organisational setting scenario planning is usually conducted by a planning team that consist of a wide and diverse range of peoples, including senior management, staff from all levels, customers, suppliers and other stakeholders (Wright, 2000: 1; Fein, 2002: 1; Analysys, 2002: 1; Granger, 1989: 225). The ideal planning team includes experts from various organisational departments – sales, marketing, operations, information technology, human resources, etc., and outsiders such as consultants, customers and suppliers (Fein, 2002: 1). Ideal candidates for the scenario team are socially intelligent, credible with relevant skills, open-minded, eager, creative and able to see the big picture (Challenge Forum, 2001: 1).

To produce the scenarios for the future of investment in the PRC, this study will employ an inductive six phase approach to scenario planning, that features many of the common concepts found in the writings of leading scenario-planners including Swartz, Ringland, van der Heijden, and many others. The process will start with the identification and analysis of key organisational decisions that will provide the focus for the scenarios, and concludes with the analysis and interpretation of the scenarios for their decision implications.

3.8.1 Step I: Identification and Analysis of the Organizational Issues That Will Provide the Decision Focus

The starting point for the scenario development process is the very specific decisions or questions that confront the organization (Business Futures, 1997: 1; Morrison & Wilson, 1997: 1; Flower, 1997: 1; Fein, 2002: 1; Kleiner, 1999: 1; Wilkinson, 2002: 1; NATO, 2002:

1; Analysys, 2002: 1; Schwartz & Ogilvy, 1998: 59; Ringland, 1998: 77). The major decisions that scenarios address range from immediate, pressing decisions (such as a major investment) to broader, longer-range concerns (such as the strategic future of the organisation) (Morrison & Wilson, 1997; Wilkinson, 2002: 1).

The first step, therefore, involves identifying, analysing and specifying the organisation's current and anticipated issues, concerns, decisions, strategies or plans that will provide the focus for the scenarios, and determining purpose of scenarios (Wilson, 1998: 84; Fahey, 1998: 192; Wack in Wilson, 1998: 355; Swartz, 1999: 241; Schwartz & Ogilvy, 1998: 59, Rossiter & Karplus & Jones, 1986: 137; South Wind Design, 2001: 1; MetaBridge, 1996: 1). This helps the organisation to maintain focus on issues that are important in order not to stray into broad generalisations about the future (Wilson, 1998: 84; Morrison & Wilson, 1997: 1).

Scenarios have been used in organisations of a variety of size – small companies through to governments and multinationals (Ringland, 1998: 39). To give several examples - scenarios have been written on the future developments in the countries such as South Africa, Russia, and Germany (the Mont Fleur Scenarios, Shell Scenarios, Insurance Company Erste Allgemeine Versicherung), for various industries including military defence (NATO), clothing industry (Levi-Strauss), health services (NHS in the United Kingdom), the information industry (3M Telecommunications System, Cable & Wireless), and the future of global environment (Electrolux, Pacific Gas and Electricity), (Kenter, 1998: 1; NATO, 2002: 1; Ringland, 1998: 30-39).

Besides determining the decision focus for scenarios, the first step also involves deliniating a time frame for the scenarios (Kleiner, 1999: 1; Bain & Company, 2002: 1; Swartz & Ogilvy, 1998: 59). The time frame in scenario planning normally ranges from 5 to 25 or more years into the future, rather than short-term developments (NATO, 2002: 1; Wilson, 1995: 1).

In some scenario analyses an identification of a company's basic mission, objectives, policies, and business domain, and an understanding of a company's points of leverage and vulnerability are also considered as integral parts of the first step (Linneman & Kennell, 1977: 143; Joyce & Woods, 2001: 190).

Additionally, some authors suggest that while framing the foundation for the scenarios the planner should also take time to consciously adopt different mindsets, to gain understanding

of personal biases, assumptions and prejudices, and to consider the possibilities from both optimist and pessimist point of view (South Wind Design, 2001: 1; Kenter, 1998: 1; GBN, 2002: 1; College of Marin; 2002: 1; Wack, 1985: 74).

3.8.2 Step II: Specification of the Key Decision Factors

The second step of scenario development entails identifying the key decision factors (Morrison & Wilson, 1997: 1). These are the main factors that decision-makers need to know about the future in order to make their decisions as the key decision factors influence the success or failure of that decision (Morrison & Wilson, 1997: 1; Wilson, 1995: 1; Ringland, 1998: 229).

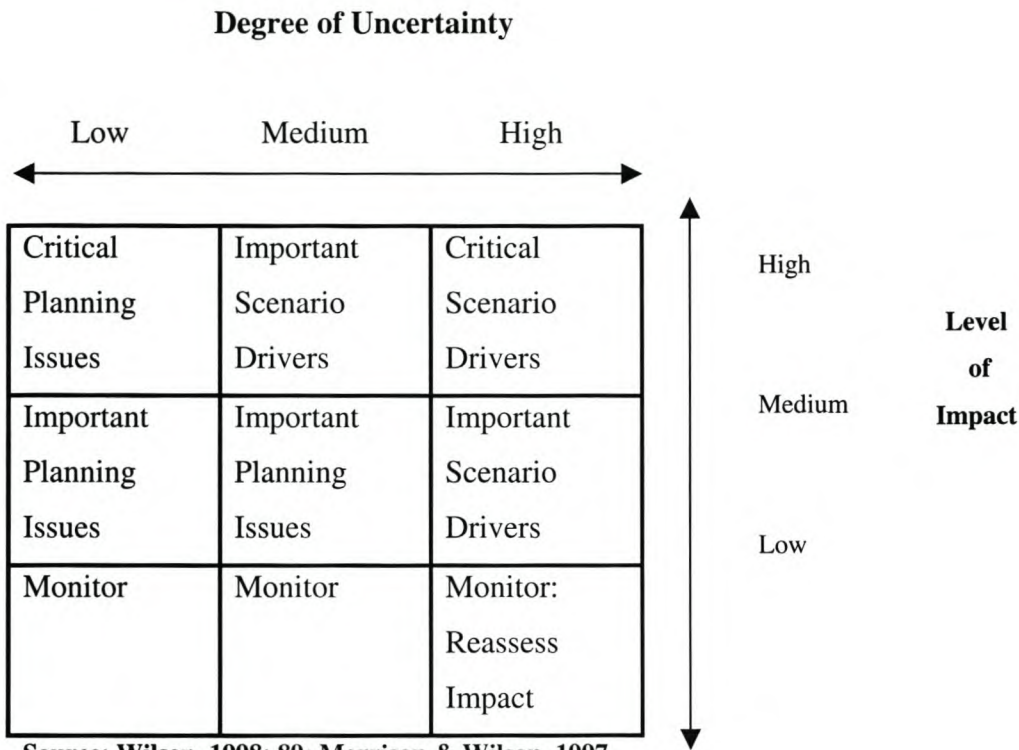
The decision key factor normally relate to largely uncontrollable conditions in the external environment (Morrison & Wilson, 1997: 1). Although the future is highly uncertain and it is implausible to certainly know future developments, it is still helpful for organizations to gain “some fix on the future course and value (or range of values) for these factors” (Morrison & Wilson, 1997: 1). Decision factors for an anticipated major foreign investment, for example, might include market size, growth, and volatility; competing products or substitutes resulting from new technology; long-range economic conditions and price trends; future government regulations; capital availability and cost; technology availability and capacity (Morrison & Wilson, 1997: 1).

3.8.3 Step III: Identification and Analysis of the Key Environmental Forces

The third step involves the identification and analysis of the key underlying factors, unexpected discontinuities, micro environmental and macro environmental driving forces that will determine the future direction and influence the key decision factors (Wilson, 1998: 86; Perrottet, 1998: 126; Fahey, 1998: 198-199; Thomas, 1998: 247; Wilson, 1998: 360; Swartz, 1999: 242; Schwartz & Ogilvy, 1998: 60; Schoemaker, 1993: 196; Oxford Analytica, 1997; Business Futures, 1997: 26; Linneman & Kennell, 1977: 146; Ingram, 1993; Kenter, 1998: 1; Flower, 1997: 1; Wilkinson, 2002; Morrison & Wilson, 1997: 1; MetaBridge, 1996: 1; NATO, 2002: 1; College of Marin, 2002: 1; Byars, 1991: 49; Ringland, 1998: 82, 229). The objective is to start building a good conceptual map of the environment, and to map out the key cause-and-effect relationships among the forces (Wilson, 1998: 86; Earley, 1998: 420; Perrottet: 1998: 126; Morrison & Wilson, 1997: 1). The aim is also to get a clear picture of

future prospects for these environmental forces: what the major trends and uncertainties are, how the forces are interrelated, which are most important in determining the key decision factors, and which best represent underlying or driving forces for significant change in the future (Wilson, 1998: 86; Earley, 1998: 420; Perrottet: 1998: 126; Morrison & Wilson, 1997: 1). To make the process less complicated many authors suggest that it is important to focus attention only on a few critical key forces that will drive the scenarios and to conclude only a few scenarios (Wilson, 1998: 8; Earley, 1998:420; Fahey, 1998: 199; Thomas, 1998: 248; Schwarz, 1999: 243; Flower, 1997: 1; Morrison & Wilson, 1997: 1).

At this stage, in order to be certain of which driving forces are truly uncertain and critical a systematic sorting out process such as an impact/uncertainty matrix can be helpful (Wilson, 1998: 88; Morrison & Wilson, 1997: 1; Jennings & Wattam, 1998: 179). With this simple matrix, each driving force can be positioned within the matrix. The driving forces can be positioned in terms of the level of their impact on the key decision factors, and the degree of uncertainty about the direction, pace, or fact of their future course (Wilson, 1998: 89; Morrison & Wilson, 1997: 1; Ringland, 1998: 230). As a result of sorting, attention can then be focused on driving forces in both high-impact/low-uncertainty cell and high-impact/high-uncertainty cell (Wilson, 1998: 89). The former cell contains forces that need to be taken into consideration in current planning (Wilson, 1998: 89). And the forces in the latter cell are potential drivers of different futures (scenarios) for which an organization's long-term planning should prepare (Wilson, 1998: 89; Jennings & Wattam, 1998: 179).

Graph 2.**Impact/Uncertainty Matrix****3.7.4 Step IV: The Selection of the Scenario Logics**

The fourth step of scenario planning entails the establishment of the scenario logics – “the organizing principles around which the scenarios are structured” (Morrison & Wilson, 1997: 1; Ringland, 1998: 82). In other words, the aim is to develop a logical, in-depth rationale and structure for the selected scenarios (Wilson, 1998: 89; Fahey, 1998: 209; Morrison & Wilson, 1997: 1). “Each distinct scenario logic is an argument about the future, a different interpretation of the uncertainties in the underlying forces that leads to a different view of the future” (Morrison & Wilson, 1997: 1).

It is obviously not practical to construct scenarios around all the high-impact/high-uncertainty forces identified in the previous step as it would result in an unmanageably high number of scenarios (Wilson, 1998: 90; Morrison & Wilson, 1997: 1; Ringland, 1998: 232). Therefore, it is important to focus on the number of critical external uncertainties that can present alternative scenarios for an organization (Wilson, 1998: 90). This can be achieved logically by developing a structure that will produce a manageable number of scenarios (Morrison & Wilson, 1997: 1).

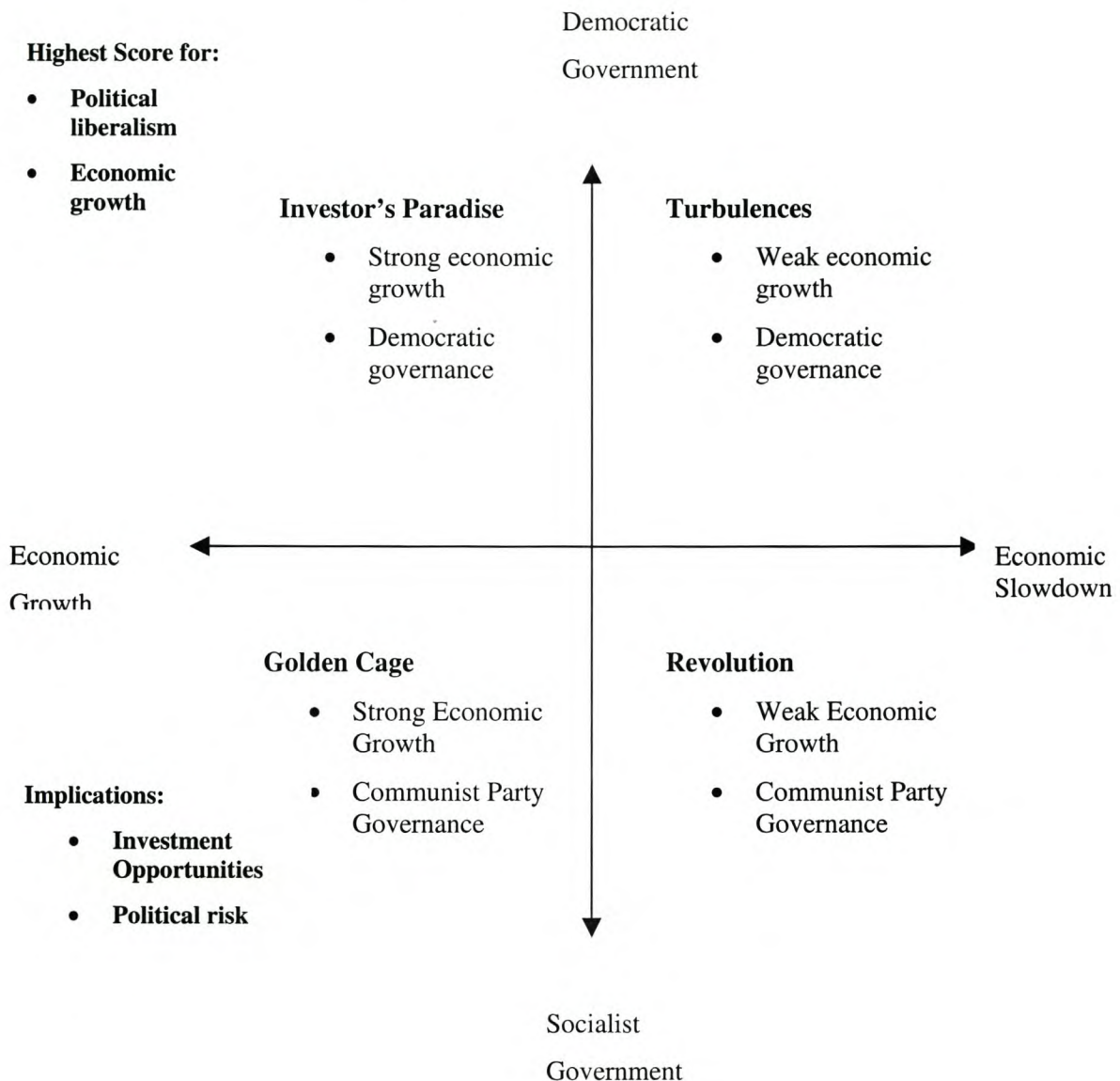
A helpful tool at this stage is a scenario matrix. The scenario matrix is built around two forces that are the most unpredictable and two forces that are the most relevant to the focal issues (Schwartz & Ogilvy, 1998: 64; South Wind Design, 2001: 1; Kairos Future, 2002: 1; Kleiner, 1999: 1; Wilkinson, 2002: 1). These four forces are the axes of a 2x2 scenario matrix as the graph 2 demonstrates (Schwartz & Ogilvy, 1998: 64; Perrottet, 1998: 128; Fahey, 1998: 202-206; Fahey, 1998: 230; Challenge Forum, 2001: 1). The four corners of the coordinate system represent four possible outcomes (South Wind Design, 2001: 1).

The advantages of the scenario matrix method are that scenarios are most likely to be logically different, and the most important key factors are drivers in all the scenarios (Schwartz & Ogilvy, 1998: 66). The scenario matrix method also includes a wild card scenario, which is based on surprising, discontinuing events that have the power to completely change the outcome of the entire future, but are not likely occur (Swartz & Ogilvy, 1998: 75; Frieswick, 2002: 1).

As an example of a 2x2 matrix we can take a look at the future developments in the PRC. The driving forces chosen for this matrix are the political environment (democratic government vs. socialist government) and the state of the economy (economic growth vs. economic slowdown). The four distinct future scenarios emerge as a result of combining these two forces. High inflows of foreign investment, for example, can be expected when the government is democratic and economic growth is strong.

Graph 3

The Future Developments in The PRC



Source: Adapted from Schwartz & Ogilvy, 1998: 65; Morrison & Wilson, 1997

3.8.5 Step V: Selection and Elaboration of the Scenarios

The fifth step of scenario planning involves identifying, selecting and elaborating the scenarios for political, economic, and social developments (in some instances for cultural, technological, psychological, environmental developments), assessing their probability of occurrence, and developing descriptions of the future under these developments (Oxford Analytica, 1997: 1, Rossiter, Karplus & Jones 1986: 138 & Linneman & Kennell, 1977: 148; Wilson, 1998: 90; Flower, 1997: 1; Ringland, 1998: 82).

The scenario planning tends to focus only on factors, which may have the possibility of affecting the client's operating environment, either positively or negatively. These factors may include government change or regime change, social upheaval, the country's international relations, the quality of governance, the general macroeconomic outlook, foreign trade and investment flows, and potential changes in the regulatory environment for trade and investment (Oxford Analytical, 1997: 1).

There are certain guidelines that are usually followed when determining which driving forces and combinations of driving forces to select for the scenarios.

Firstly, it is important that the scenarios explain the probable range of future outcomes and not the entire possible range (Courtney, Kirkland, & Viguerie, 1999: 14; Morrison & Wilson, 1997: 1; Analysys, 2002: 1).

Secondly, the selected scenarios must be plausible, meaning that they must develop logically from the past and the present (Wilson, 1998: 91; Fahey, 1998: 214; van der Heijden, 1996: 187, 213; Schoemaker, 1993: 197). Scenarios must be based on credible, feasible, realistic, and relevant hypothesis (Linneman & Kennell, 1977: 146; Fahey & Randall, 1998: 9). Plausible evidence should indicate that the projected scenario could take place, demonstrate how it could take place, and illustrate its implications to the organization (Fahey & Randall, 1998: 9; Morrison & Wilson, 1997: 1). It is important that all the key parts of a scenario are questioned, and that those elements found to be inconsistent and illogical should be reconsidered (Fahey & Randall, 1998: 9).

Thirdly, each scenario should be simple, vivid, convincing and be distinctly different from other scenarios in the set (Sunter & Ilbury, 2001: 87; Linneman & Kennell, 1977: 146; Schoemaker, 1998: 425; Schwartz & Ogilvy, 1998: 57; Spies, 1982: 17; Wilson, 1998: 91; Morrison & Wilson, 1997: 1; MetaBridge, 1996: 1).

Fourth, scenarios should be internally consistent and logically structured (Wilson, 1998: 91; Fahey, 1998: 211; Fahey, 1998: 235; Kania, 1998: 269; van der Heijden, 1996: 187; Schoemaker, 1993: 197; Kenter, 1998: 1; Morrison & Wilson, 1997: 1; MetaBridge, 1996; Analysys, 2002: 1; Wack, 1985: 146; Business Futures, 1997: 27). This means that all the elements in the scenarios must be fundamentally compatible and related through cause and effect lines of argument (Kania, 1998: 269; van der Heijden: 1996: 187).

Fifth, each scenario should contribute specific implications and insights into the future decisions, plans, strategies and directions, and challenge the organisational thinking about the future (Courtney, Kirkland & Viguerie, 1999: 14; Business Futures, 1997: 26; Wilson, 1998: 91; van der Heijden, 1996: 187; Morrison & Wilson, 1997: 1; MetaBridge, 1996: 1; Wack, 1985: 137). The scenario process should not be an isolated activity, unconnected to the organization's decision-making process (Schoemaker, 1998: 427). Thus, Scenarios are most effective and useful when they are written from the organization's perspective, and integrated with other organizational decision-making processes (Wright, 2000: 1).

Finally, the most important aspect of scenario planning is the underlying assumptions (Schnaars, 1987: 155, 164; Wright, 2000: 1). Two empirical studies conducted by Ascher and Schnaars support the view that the most frequent reason for errors in scenarios is that they are predicted on inaccurate underlying assumptions (Schnaars, 1987: 155). Thus, the general consensus is that it is better to consider a number of plausible assumptions, rather than a single one which may later turn out to be incorrect (Schnaars, 1987: 155). Scenario planning is about challenging the underlying assumptions (Wright, 2000: 1; Bain & Company, 2002: 1; GBN, 2002: 1; Wack, 1985: 74). The purpose is to avoid making decisions or statements based on wrong assumptions or even ignorance that can have detrimental results - such as was Winston Churchill's statement in 1939, declaring that "atomic energy might be as good as our present day explosives, but it is unlikely to produce anything very much more dangerous" (Wright, 2000: 1).

Once the scenarios have been selected, they have to be elaborated. At this point, all they have by way of description is a combination of two driving logics (Morrison & Wilson, 1997: 1). There are many ways to elaborate the description of scenarios. However, there are two important aspects that should be carefully considered.

First of all, each scenario needs a highly descriptive, unique and memorable name (Wilson, 1998: 91; Morrison & Wilson, 1997: 1; Swartz & Ogilvy, 1998: 78; Kleiner, 1999: 1; Challenge Forum, 2001: 1). For example, the four 'Mont Fleur' scenarios, developed to explore the alternative futures for the new South Africa during its first ten year period (1992-2002) by a diverse group of South Africans from politics, academia and business in 1991, were creatively called 'Ostrich', 'Lame Duck', 'Icarus', and 'Flight of the Flamingoes' (Kahane, 1998: 325).

Secondly, it is also important that scenarios have compelling, logical, and plausible story lines of how events might unfold between now and a future date (Wilson, 1998: 92; Morrison & Wilson, 1997: 1).

And lastly, the scenarios, elaborated with graphs, charts, and other visual material, can help bring the scenarios to life (Morrison & Wilson, 1997: 1).

3.8.6 Step VI: Interpretation of the Scenarios for Their Decision Implications

The last step of scenario planning deals with the analysis and interpretation of the scenarios for their decision implications (Wilson, 1998: 92; College of Marin, 2002: 1; Ringland, 1998: 82). This entails determining what are the strategic implications of the scenarios which lead to a particular decision, developing strategic insights, and highlighting direct links between potential political, economic and social developments and the client's strategic and operational activities (Wilson, 1998: 92; Perrottet, 1998: 132; Ward & Schrieffer, 1998: 153; Oxford Analytica, 1997: 1).

The aim of the last step is to provide a company with a clear sense of what the company's opportunities and risks are likely to be in the future (Rossiter, Karplus & Jones 1986: 139). Scenarios cannot remove uncertainties (Fein, 2002: 1). However, scenarios help organizations to come to a reasonable judgment about whether a specific strategy will be potentially successful across a range of possible futures (Fein, 2002: 1).

There are a number of approaches that may help interpret the scenarios. The first possible approach is to examine threats and opportunities, and how prepared the organization is to seize the opportunities and minimize the threats (Wilson, 1998: 93; Byars, 1991: 49). Secondly, assessment of both the resilience and vulnerability of an organization's current strategy may be beneficial (Wilson, 1998: 93). Thirdly, the development of a strategy, which is specific to the circumstances and conditions in each scenario, is very useful (Wilson, 1998: 93; Perrottet, 1998: 132). Strategies should be suitable for a wide variety of plausible futures, and help organizations to think the unthinkable, prepare for the future, and identify interesting emerging opportunities (Perrottet, 1998: 137; Ringland, 1998: 12). Lastly, strategies, necessary changes, and decisions that will move the organization towards the desired future state should be considered and identified for each scenario – should any of the scenarios materialize (Wright, 2000: 1; Coles, 2000: 1).

To test the usefulness of scenarios it is good to ask two questions:

- What do the scenarios leave out?
- Do the scenarios lead to action? (Wack, 1985: 146)

It is also important to evaluate the strategy and identify some key indicators that can be scanned and monitored on a continual basis (Wilson & Randall, 1998: 382; Wilson, 1998: 362; Schwartz, 1999: 246; Wright, 2000: 1, Coles, 2000: 1; Morrison & Wilson, 1997: 1; Flower, 1997: 1; Bain & Company, 2002: 1; Frieswick, 2002: 1; Byars, 1991: 49; Simon, 1982: 68). Morrison and Wilson call this environmental scanning and monitoring and suggest that establishing a continuous scanning/monitoring system is necessary. In this two-phase process environmental scanning identifies early warning signals of new trends and developments that might become important in the future (Morrison & Wilson, 1997: 1). “The earlier the warning, the more lead time the organisation has to plan for the implications of these changes” (Morrison & Wilson, 1997: 1). Environmental monitoring, on the other hand, entails selecting trends and events that are important and potentially critical, and collecting data periodically on them (Morrison & Wilson, 1997: 1). These data are monitored so that changes in their status can be discovered (Morrison & Wilson, 1997: 1). The purpose of monitoring is to determine the past and possible future directions of trends or to enable decision-makers to estimate the strength of indicators of potential events (Morrison & Wilson, 1997: 1). Scenario planning at its best is an ongoing process that constantly tracks the critical developments in the environment (Analysys, 2002: 1).

3.9. Summary

As this chapter has shown the scenario-planning method as a forecasting tool provides insightful information necessary to understand, anticipate, and respond to change and uncertainty in an increasingly global world environment. Although the future cannot be forecast or predicted with certainty, the very process of thinking about the future and exploring the implications of alternative futures may have a profound impact on foreign investment. The six steps of scenario planning introduced in this chapter will be later applied to the case study on political risks in the PRC. However, prior to the case study the fourth chapter will present a background study of the PRC in which the historical setting, current economic, political and social trends, and foreign investment and trade with the PRC will be reviewed.

CHAPTER 4

Background Study of The PRC

4.1 Introduction

This chapter presents a background study of the PRC in which the current economic, political and social trends, as well as foreign investment and trade with the PRC will be reviewed. The background study will subsequently help in the construction of the four “the PRC 2022” scenarios. The focus will be on the opportunities and challenges arising from the PRC's emergence as a global political, economic, and military power. The most recent developments and reforms on the economy, society, government organization and institutions will be examined. The remaining challenges will also be reviewed, including population increase, the plight of rural poor, rapid urbanization and potential political change.

4.2 The PRC's Political Environment

4.2.1 Introduction to The PRC's Political Environment

The People's Republic of The China (PRC) is a socialist state in which the Chinese Communist Party (CCP) is the dominant source of power at both central and local levels of governance (East Asia Branch, 2002: 5; China, 1999: 88). The CCP's highest body is the National Party Congress which meets in general every five years (East Asia Branch, 2002: 5). The Congress elects a Central Committee which functions as the highest organ of the party between Congresses (East Asia Branch, 2002: 5). The Central Committee in plenary session elects a 22-member Politburo and the General Secretary of the Party – the PRC's ultimate authority (East Asia Branch, 2002: 5).

The National People's Congress (NPC), the highest state body and the PRC's parliament, is convened every five years and holds one session every year (East Asia Branch, 2002: 5). The NCP's main functions revolve around the appointment and removal of the top leadership of the People's Republic, the State Council, the Supreme People's Court, and the State's Military Commission, the amendment of the Constitution, the enforcement of laws, the development and approval of national economic and social planning, as well as the State Budget (East Asia Branch, 2002: 5).

In the 2001 session of the 9th National People's Congress confirmed the government's commitment to economic reforms as an imperative for sustained economic growth (East Asia Branch, 2002: 7). The tenth five-year plan was launched with a target to double the 2000 GDP by 2010 and achieve economic growth of 7% per annum (East Asia Branch, 2002: 5; www.china.org). The NPC also recognised the need to deal with rising social and economic problems, including unemployment, corruption, low overall industrial quality and poor competitiveness, as well as a growing income disparity (East Asia Branch, 2002: 7; www.china.org).

The CCP's influence extends into almost every aspects of life, including education, industry, commerce, and the military (Hunter & Sexton, 1999: 101). The CCP's authority rests primarily on the Government's ability to maintain social stability, appeals to nationalism and patriotism, Party control of personnel, media, and the security apparatus, and the continued improvement in the living standards of the country's citizens. Although socialism continues to provide the theoretical foundation of national politics, Marxist ideology has given way to economic pragmatism and economic decentralization.

The view that the Communist Party has managed to pursue economic reform without political reform is somewhat incorrect (Minxin Pei, 2001: 2; Lardy, 2002: 1; Suisheng Chao, 1999: 1). Over the past twenty years a number of important political reforms have been undertaken, including the strengthening of national and local legislatures, a mandatory retirement system for government officials, and experiments in rural self-governance and elections (Minxin Pei, 2001: 2; Suisheng, Chao, 1999: 1). The government has also attempted to increase its accountability by holding public hearings through local people's congresses on controversial issues in order to solicit public opinion, and allowing citizens to sue the government (Lardy, 2002: 1).

4.2.2 Change in Government Leadership

During 2002-2003 the PRC's political scene will be dominated by the change in government leadership, as the present generation of government leaders will be retiring in March 2003 (Davies & Richardson, 2001:1; Kynge, 2002: 1; Mukherji & Ogawa, 2001: 3). It is likely that Hu Jintao, one of the PRC's vice-presidents, will succeed the president, Jiang Zemin (CNN, 24/04/2002: 1; Kynge, 2002: 1; Mukherji & Ogawa, 2001: 3). Although, there are signs that Jiang would like to hold on to his post of Communist party General Secretary, in addition to

Chairman of the Central Military Commission (CMC) (Wo-Lap Lam, 03/07/2002; Kynge, 2002: 1). Several army generals, members of the CCP, and famous writers and scientists are circulating petitions asking Jiang to stay despite his having exceeded by five years the unwritten but widely accepted retirement age of 70 (Wo-Lap Lam, 03/07/2002). If Jiang is to retire he is most likely to keep a strong behind-the-scenes presence (Wo-Lap Lam, 03/07/2002: 1; Forney, 2002: 1). The other positions are expected to be allocated to current members of the CCP's politburo standing committee (PSC) (Mukherji & Ogawa, 2001: 3).

4.2.3 Economic Liberalism and Political Control

Leadership change is not expected to bridge the growing gap between increasingly open economic society and political control by the Chinese Communist Party (CCP) in the near future (Nathan, 2002: 1; Minxin Pei, 2001: 1; Mukherji & Ogawa, 2001: 3). Many analysts believe that the new government is likely to hold on to the socialist ideology, separate business from politics, and to avoid any bold political reforms (Nathan, 2002: 1). However, the increasing input from pragmatic technocrats in decision-making, greater internal political debate, increasing economic affluence of party members, cooperation with other countries, the PRC's commitment to economic reform and the WTO membership are factors that may lead to political reform of the government in the longer term (Minxin Pei, 2001: 2; Mukherji & Ogawa, 2001: 3).

The level of internal debate on political and social issues has already been risen and spilled over into the public domain (Mukherji & Ogawa, 2001: 3). A recent move to formally admit private entrepreneurs continues the gradual transformation of the party (Mukherji & Ogawa, 2001: 3). In addition, the party has realised that in order to win popular confidence and support, it needs to implement policies that will improve discipline and oppose corruption, particularly within the party (Callick, 2001: 2; Kynge, 2002: 1; CNN, 05/03/2002: 1). As a result of aggressive anti-corruption measures, several prominent party officials, including senior official in the Bank of China and a few provincial leaders, have been exposed and found guilty of corruption and punished (CNN, 09/03/2002: 1; Kynge, 2002: 1).

4.2.4 The Freedom of Expression

Maintaining political and social stability is one of the corner stones of the government's policy. In recent years, the Chinese government has taken steps to protect ethnic minorities,

freedoms of religious beliefs, and the promotion of 'freedom of expression' through public hearings. However, as the latest conduct and responses demonstrate the government is prepared to repress political or social forces that are perceived as threats to the government's authority. In recent months, regional magazines and reporters, for instance, have been warned that reporting on issues such as major corruption scandals, criminal cases, Falun Gong, Tibet, labour protests, or human and natural disasters is an illegal activity, unless material is issued by the official Xinhua news agency (Demaria, 2002: 1). The consequence has been crackdown on the scope of news reporting and instant closure of the publications. Since the announcement, at least one newspaper have been closed, and a number of reporters have been fired for their reports on corruption and crime or unwillingness to work within the boundaries of "self-censorship" (Demaria, 2002: 1).

Similarly, in its efforts to control the flow of information, nearly 60 000 Internet cafes nationwide have been investigated in government-instigated crackdowns, and about 1900 Internet Cafes have been forced to suspend operations until the imposition of stronger systems of self-censorship or monitoring, since mid-2001. With the number of people online growing at the pace of 4-6 percent a month, and more sophisticated methods of breaching firewalls being used, attempts to regulate how people use the Internet will remain concern to the government (Chinoy, 2001: 1; Helsingin Sanomat, 2002: 1).

The government is also determined to punish and crack down on any individuals or movements that distribute subversive material, organize illegal meetings, and are critical of state organizations. For example, the Chinese government remains determined to discredit and suppress the Falun Gong movement, which was banned as an evil cult in the PRC in 1999 and later in 2001 branded as a "quasi-terrorists sect" (Demaria, 2002:1). According to the claims of foreign human-rights groups about 10 000 members of Falun Gong have been sent to serve sentences in labour camps since the "cult" was outlawed (Demaria, 2002: 1; CNN, 05/03/2002: 1).

As recent developments illustrate, there is no real freedom of debate, publication, or association in the PRC. It is likely that the government will continue to maintain strict control on social protests, opposition parties and the media, including the Internet, in the near future.

4.2.5 *International Relations and Foreign Policy*

Economic growth over the past two decades has enabled the PRC to assert a greater role for itself in international political affairs (Leeb, 2002: 1). The PRC's guiding principles have been to secure a stable and favourable internal environment in order to concentrate on economic development and internal policy challenges, to open up the economy to the outside world, to safeguard the sovereignty of the country and international peace, and to develop and maintain mutually beneficial and cooperative relations with other countries (Leeb, 2002: 1; China, 1999: 108-109; East Asia Branch, 2002: 7).

Issues and objectives that are important on the PRC's agenda in terms of foreign diplomacy are to gain support for the PRC's Taiwan policy, to secure border agreements with neighbouring countries, to enhance the PRC's prestige abroad, to promote international trade, and to develop economic ties (Leeb, 2002: 1; China, 1999: 108-109). During the past two decades the PRC utilized both bilateral and multilateral diplomatic approaches. This has not only bolstered the PRC's status and importance in the world, but also enabled the PRC to achieve its goals and objectives in relations to other countries (Leeb, 2002: 1; East Asia Branch, 2002: 7).

Many countries, however, are sceptical about the PRC's intentions. As the PRC's economic prosperity strengthens, many fear that the PRC will take a more assertive military approach and reach for regional hegemony. For the past decade, the PRC has, indeed, been engaged in a sustained effort to modernize its military forces (Leeb, 2002: 1). The military budget has nearly tripled since the early 1980's (Leeb, 2002: 1).

4.2.6 *Sino-US Relations*

Relations between the PRC and the US in the 1990's were dominated by US concerns about trade and human rights (Hunter & Sexton, 1999: 190). The US accused China of unfair trade practices, including dumping, counterfeiting goods and restricting access to its home markets, and expressed its disapproval of the PRC's human rights practices on a number of occasions (Hunter & Sexton, 1999: 190).

The PRC's relations with the US, however, improved substantially after the September 11 as the PRC did not condemn the US war against terrorism in Afghanistan (Davies & Richardson,

2001:1). The Chinese government's response to the terrorist attacks demonstrates the PRC's commitment to both internal and external political stability, and represents a significant change in the PRC's foreign policy. The PRC, which has previously opposed military intervention in sovereign states, now supports the American-led anti-terrorism campaign. However, the PRC has criticised the US plans to undertake pre-emptive strikes against terrorists and their supporters (Wo-Lap Lam, 15/07/2002).

Although the PRC has no plans to engage in military expansion, it still views Taiwan as a part of Mainland China– a province that needs to be reclaimed, which is a potentially explosive situation in Sino-US relations (CNN, 12/05/2002: 1; Nautilus Institute, 2000: 3). The Sino-US bilateral relations have been threatened a number of times over the Taiwan issue, which has complicated relations between the two countries. The US has angered the PRC occasionally by actions such as referring to Taiwan as a country, and by selling arms to Taiwan (Reuters, 06/04/2002: 1; CNN, 02/04/2002: 1).

The PRC firmly opposes to the US plans for National and Theater Missile Defence (NMD and TMD) programmes, which it perceives as aimed entirely at containing the PRC's development defensive and offensive capability (CNN, 13/03/2002: 1; Nautilus Institute, 2000: 2).

In the future Sino-US relations will be largely shaped by how the PRC adapts to the WTO rules on trade and investment (Nautilus Institute, 2000: 2). The PRC's WTO membership will increase inflows of foreign direct investment.

4.2.7 Sino-Russian Relations

The PRC and Russia have shared a number of common interests over the years. In the late 1990's the PRC wanted to modernise its armed forces and Russia was desperate to find markets for its arms (Hunter & Sexton, 1999: 193). Both governments have been irritated with the US dominance and American foreign policy on a number of occasions (Hunter & Sexton, 1999: 193). In 1997 the PRC and Russia signed a strategic partnership agreement in which Russia agreed to recognise Taiwan and Tibet as inseparable parts of the PRC, oppose Western influence in the PRC's internal affairs, and the PRC promised to buy Russian weapons (Hunter & Sexton, 1999: 193). Despite the recent understanding, mistrust between the countries exists. For instance, Russia is concerned that the PRC might attack or encourage

large-scale immigration to its under-populated and remote eastern regions (Hunter & Sexton, 1999: 193).

4.2.8 *'One Country, Two Systems' Policy*

The PRC is still committed to its 'one country, two systems' policy, and the reunification of the country. Even though the missile build-up on the Chinese coast opposite Taiwan will continue in 2002-2003, it is highly unlikely that the PRC will attempt to attack on Taiwan during this time. The PRC will not risk losing the economic benefits derived from massive inflows of Taiwanese FDI, which was an impressive \$1.5 billion in 2000 (Garten, 2001: 24).

4.2.9 *Asian Neighbours*

The PRC's efforts to build closer ties with its Asian neighbours by forging military, political and economic alliances with the countries on its borders is continuing, at least partly in an attempt to project itself as the preponderant regional power (Hunter & Sexton, 1999: 194). In countries such as Cambodia, Burma, Vietnam and Laos the PRC is helping to build infrastructure, and providing much needed FDI. There are, however, a number of issues that are causing tension between the PRC and its Asian neighbours, including the territorial dispute over the Spratly Islands, and reunification of North Korea and South Korea (Hunter & Sexton, 1999: 194).

4.2.10 *Sino-Japanese Relations*

Relations between the PRC and Japan have considerably improved in recent years. For the first time in 1998 Japan expressed an apology to the Chinese people regarding its aggression against the PRC during the Second World War (www.china.org.cn). The Japanese have also announced that it would not participate in any activities supporting for the independence of Taiwan (www.china.org.cn). In the economic front, the PRC and Japan are major trading partners. During the past seven years Japan has been the PRC's largest trading partner. Since the economic reforms began Japan has been one of the most important sources of investment in the PRC, and has provided considerable official development aid (ODA) to the PRC (China Daily, 2002: 1).

The relations between the PRC and Japan, however, are constrained by the developing rivalry for regional dominance, and unsolved territorial dispute over Diaoyu Island (Senkaku Island) in the East China Sea. Sino-Japanese relations will also continue to be troubled by frictions regarding military and defence issues (China Daily, 2002: 1). Japan, particularly, feels intimidated by the Chinese missile defence programme.

4.2.11 Sino-Indian Relations

The PRC's relations with India have remained generally friendly over the years, despite the developing rivalry for regional dominance. Sino-India relations are expected to be dominated by India's nuclear weapons programme, the PRC's growing presence in Burma as its primary military supplier, the PRC's tight military relationship with Pakistan, the unresolved border dispute between India and the PRC, a growing Chinese Naval presence in the Indian Ocean, and economic rivalry (Weaver, 2002: 1; Sommers, 2001: 18; Hunter & Sexton, 1999: 196). Bilateral trade and investment is expected to quickly increase now that both countries are members of the WTO (Weaver, 2002: 1). Anti-terrorism efforts against Muslim separatism might also bring the two countries closer (Weaver, 2002: 1).

4.3 The PRC's Economic Environment

4.3.1 Economic Growth

The PRC has experienced 20 years of rapid economic growth (Schiffers, 1999: 1; Leeb, 2002: 1). Statistics show that the GDP has increased from \$176 billion in 1979 to \$1.08 trillion in 2000 (Lau, 2001: 3; World Bank, 2001: 1). The average annual real growth rate of GDP for 1990-2000 was 10.3%, which was one of the highest growth rates in the world (World Bank, 09/06/2001: 1). Today, the PRC is the seventh largest economy in the world – nearly the same size as the UK or Italy (Schiffers, 1999: 1; Lardy, 2002:1).

The first major reason for the PRC's rapid economic growth has been a huge inflow of foreign direct investment (FDI) over the years. During the past eight years the PRC has been the second largest recipient of FDI in the world after the United States (US). The PRC now accounts for about one-third of the global emerging market's total stock of FDI (Economist, 03/10/2002: 24). Strong confidence in the PRC's economy has continued despite the recent global slowdown.

The second reason for the PRC's extraordinary economic growth is the fact that since the opening to the outside world, the PRC has assertively expanded into the international markets (Hunter & Sexton, 1999: 68; www.china.org.cn). The PRC's foreign trade has grown from about \$20 billion in 1978 to \$474 billion in 2000, a 24-fold increase (Fewsmith, 2001: 573).

Remarkable gains in productivity, a consistently high domestic savings rate, rapid structural transformation from the former planned economy to a more open economy, and the development of a vibrant non-state sector are all factors that have contributed towards the PRC's phenomenal economic growth (ADB, 1996: 3).

Also, in recent years the Chinese government has increased internal investment in the economy, and stimulated domestic consumption in order to sustain high levels of economic growth and to limit the PRC's vulnerability to external shocks (East Asia Branch, 2002: 8; Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 1; Davies & Richardson, 2001:1; BBC, 09/04/2002: 1; McMillan, 2002: 1; BBC, 15/07/2002: 1). This strategy has been successful in the context of the recent world economic slowdown. For reference, GDP in the East Asia (Indonesia, Korea, Malaysia, Philippines, and Thailand) rose by 2.4 percent, while the PRC's official GDP estimates were 7.0 percent and 6.6 percent respectively in the last two quarters of 2001 (World Bank, 2002: 1). The State Development Research Council has predicted that annual growth of 7-8% will be maintained between 2002 and 2005 (BBC, 09/04/2002: 1).

4.3.2 Production and Export-Driven Economy

The PRC is an export-driven economy. The PRC's exports are at least 23% of GDP, making it the world's ninth-largest exporter (Economist, 03/10/2002: 24). External performance has remained strong over the past two years, despite the global slowdown. In 2001 export growth was 6.8 percent (World Bank, 2002: 6). Imports have also been gradually growing. In 2001, imports rose by 8.9 percent (World Bank, 2002: 6). Due to the World Trade Organization (WTO) entry, imports can be expected to continue to grow faster than exports, hitting 10% in 2002 and 14% in 2003 (BBC, 09/04/2002: 1).

The PRC has large industrial and agricultural sectors, and is a leading producer of coal, steel, textiles, and grains (www.china.org). The PRC has become a leading low-cost manufacturer and exporter of such goods as toys, wearing apparel, plastics, footwear and sporting goods, and has increased its share in manufacturing and exporting information technology, hardware

and electronics (Lardy, 2002: 1; PriceWaterHouseCoopers, 2002: 1). This is largely a result of government policies, including investment in infrastructure, price regulations and subsidies, that have encouraged the growth of export-oriented manufacturing (ADB, 1996: 4). The important role of FDI in the production sector, however, is evident. In 2001 over half of all the Chinese exports in international markets were produced by firms with foreign investment, either joint ventures or wholly foreign owned companies (Lardy, 2002: 1; Bixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 2). In the recent years, foreign-owned enterprises have also been the strongest performers, partly due to the continuing flows of FDI (World Bank, 2002: 1; Bixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 2).

4.2.3 The PRC's Accession to the World Trade Organization (WTO)

In 2001 The PRC joined the WTO. The membership is predominantly viewed as a great opportunity for the PRC to establish itself as a major participant in the global economic community. Additionally, the membership is widely expected to stimulate new investment, expand opportunities for foreign firms, speed up the economic reform process, bring in increased competition, and improve the PRC's external relations (Hansen, 2000: 3). Under WTO rules, the PRC is now guaranteed non-discriminatory access to the markets of all major industrial countries (Fewsmith, 2001: 574; BBC, 15/11/1999: 1). In return, the opening of the Chinese market - with its 1.3 billion people - provides increased opportunities for foreign businesses, particularly in the areas of financial services, insurance, securities, telecommunications, retail, distribution and agriculture (Hansen, 2000: 1-2; Kirby, 2001: 1; The China Daily, 2002: 1; BBC, 15/11/1999: 1; Economist, 03/10/2001: 23; Lardy, 2002: 1; Yam, 2001: 1; Tsoi & Lan, 2002: 2-4).

By joining the WTO, the PRC has agreed to undertake a number of important commitments and obligations to open and liberalise its regime to better integrate in the global economy and offer a more predictable environment for trade and foreign investment (East Asia Branch, 2002: 9). As a result, the PRC will provide non-discriminatory treatment to WTO members, reduce tariffs to a level that is lower than any other developing country, diminish restrictions on a number of products and foreign-owned enterprises, revise and enact new legislation in compliance with the WTO agreement, reform the banking sector, and gradually end the protectionism of the PRC's state-run enterprises (Tsoi & Lan, 2002: 1; Hansen, 2000: 2; Kirby, 2001: 1; WTO News, 2001; Fewsmith, 2001: 574; BBC, 15/11/1999: 1; Garten, 2001: 24; Lau, 2001: 21; Yam, 2001: 1; East Asia Branch, 2002: 9).

A recent study by Goldman Sachs estimates that with WTO membership, the PRC's total trade (exports plus imports) will double from 1998's \$324 billion to \$600 billion in 2005 (Hansen, 2000: 2). It has also been estimated that accession to WTO will attract \$1 trillion of foreign investment between 2001 and 2005 (as compared with \$2.5 trillion over the decade of the 1990s) (Fewsmith, 2001: 574). However, as many believe the WTO accession will lead to higher unemployment and greater income disparities in short term.

4.2.4 The PRC's Reforms and Restructuring

After gaining power in 1978, two years after Mao's death, Deng Xiaoping began to introduce economic reforms, hoping to eliminate inequalities, promote self-reliance and develop the PRC into a modern industrial state (Schifferes, 1999: 1; Economist, 26/10/2001). Since then structural reforms, the establishment of modern economic institutions, and restructuring have continued to be a part of the government's overall strategy as they are the key to long-term growth, stability and inflow of FDI (www.china.org.cn; Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 4). Many macroeconomic policies and institutional reforms have already brought visible success and economic transformation. The increase in productivity have led to substantial improvements in real income, and living standards, and progress in poverty reduction (ADB, 1996: 1). Rapid industrialisation has led to the declining share of agriculture and other primary industries in the economy (ADB, 1996: 4). Many of the inefficiencies and inflexibilities of the former centrally planned system have been eliminated or reduced, and the general public has increasingly been allowed to participate actively in the economy (ADB, 1996: 1; Leeb, 2002: 1; Hunter & Sexton, 1999: 73). As a result, a vibrant non-state sector has emerged to compete with the state sectors (ADB, 1996: 1).

However, there are a number of reforms that remain to be executed to complete the shift from a relatively closed centrally-planned economy to an open market economy.

Public Spending and Infrastructure Developments

The government's approach to support public spending and inward investment in the PRC's infrastructure is an attempt to boost consumer confidence and private spending, and provide much needed jobs (Hansen, 2000: 2; Kynge, 2002: 1; Mc Millan, 2002: 1; BBC, 15/07/2002: 1). The sectors that have already benefited from increased government spending and strong inward investment include real estate, infrastructure, textile, machinery and electronic

industries (Davies & Richardson, 2001: 2). In recent years the government has also increased social spending and public sector salaries (Davies & Richardson, 2001:2; Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 4; World Bank, 2002: 3).

Legal Sector Reforms

Another step taken by the government to strengthen the PRC's weak institutional structure is the 'cleaning up' operation of the legal and regulatory sectors (Davies & Richardson, 2001:2; ADB, 1996: 2). The government has already begun the process of transformation by training more lawyers, and establishing new courts (Mukherji & Ogawa, 2001: 3). As a result of the WTO entry the Chinese government is expected to establish an effective legal system by issuing new laws and amended laws governing foreign investment in the service sector, including those dealing with foreign participation in foreign exchange banking, railway and road transportation, hospitals, cinemas, construction and engineering design, accounting, telecom, securities, mutual funds, education, and legal services (Waterman, 2002: 1; Garten, 2001: 24). Other laws related to tax, franchising, direct selling, antitrust, safeguards, and antidumping are also expected to be considered in near future (Waterman, 2002: 1; Garten, 2001: 24).

Tax Reforms

The government plans to reform tax administration into a transparent and effective tax system which should strengthen government revenue collection capacity, as well as to monitor and crack down on local-government corruption (BBC, 04/07/2002: 1; Economist, 03/10/2002: 23; Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 5; Mukherji & Ogawa, 2001: 7).

Corporate Sector

The government has also taken steps to reform and restructure the corporate sector by improving the use of resources, and by maintaining stability on the financial and social fronts (Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 1). The recent campaign targeted on fraud, irregularities and corruption in the corporate sector, privatization of SOEs, ownership transformation, and policies and institutional developments regarding pensions have all been a part of corporate sector reform and restructuring (Callick, 2001: 2; Economist, 03/10/2001: 23; Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 6). The government has also called for

“more competition in monopolistic sectors such as power, railway, communication, and greater involvement by the private sector in SOE restructuring, and equal treatment for enterprises of all kinds of ownership” (Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 6). The invitation of private entrepreneurs to be included in Party membership also indicates that a substantial change in attitudes and policies towards free market economy and private enterprise are under way (Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 6). The invitation of private entrepreneurs to be included in Party membership also indicates that a substantial change in attitudes and policies towards free market economy and private enterprise are under way (Brix, Hau, Liu, Scott, Szeto & Zhang, 2001: 6). As a result, the private sector accounts for more than 60% of the GDP (Lau, 2001: 2).

State-owned Enterprises (SOEs)

The transformation of the inefficient and overstaffed state-owned enterprises (SOEs) into internationally competitive and profitable businesses has been on the government’s agenda for a number of years now (Schiffers, 1999: 5). According to statistics SOEs consume about two-thirds of socio-economic resources while contributing only one-third of the national GDP (Lu Xueyi, 2000: 1). Additionally, a recent survey has shown that as many as 90% of the SOEs are overstaffed, with the average level of excess workers at 25% (Leeb, 2002: 1). Restructuring will be achieved by granting subsidies and new technology, reducing state ownership, and allowing more mergers and bankruptcies (World Bank, 2002: 2; Mukherji & Ogawa, 2001: 4). It will also require developing some type of social security system and pension scheme “so that surplus labor can be reallocated from SOEs in a manner that keeps the associated social costs within acceptable limits” (ADB, 1996: 2). It will also require developing some type of social security system and pension scheme in order to prevent social unrest as releasing the SOE workers is going to cause a flood of unemployment in the market (ADB, 1996: 2; BBC, 09/04/2002: 1).

The Banking and Financial Sectors

During the past two decades the PRC has taken a number of significant steps to transform its banking system. The central bank – the People's Bank of China now regulates, controls and supervises the new financial system (China, 1999: 156; www.china.org.cn). Four state-owned national commercial banks and three policy management banks provide the main financial body (China, 1996: 156; www.china.org.cn). Since 1996, a number of joint-stock commercial

banks have been established, and the banking businesses have become more diversified (China, 1999: 156; www.china.org.cn). A number of foreign-capital and Sino-foreign joint-venture financial organizations have also been set up in the PRC's special economic zones and in the larger cities (China, 1999: 156; www.china.org.cn). One of the benefits of the WTO entry is that within five years foreign-funded banks will be allowed to establish financial business services, to handle Renminbi business in the country, and to deal with all Chinese enterprises (www.china.org.cn; Yam, 2001: 1; Tsoi & Lan, 2002: 2). This is expected to lead to the growth in financial services, greater banking competition, the full introduction of commercial principles, market-based credit policies, and improvements in accounting standards, and greater transparency and accountability (Yam, 2001: 1). The banking sector, however, is still burdened by high levels of non-performing loans (East Asia Branch, 2002: 9). In order to solve this, the government has recently reduced the tax burden on banks and allowed greater flexibility in writing-off bad debts (Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 1).

The Chinese government has taken a number of important steps in other sectors of the economy as well. In order to strengthen the insurance market, for instance, special task forces have been set up to uncover irregularities and non-ethical practices by insurers (Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 9). Also, to control stock market practices the government has begun to crack down on bank financing of stock market speculation and has taken action against several corrupt securities firms (Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 9).

The PRC's transition from a state-controlled market economy to a consumer market economy will not be easy. The PRC will definitely face many economic and social challenges in the first decade of the new millennium as the next section on the PRC social environment will demonstrate. However, it is believed that economic reforms are irreversible (Leeb, 2002: 1). There will no doubt be differences over how, and how quickly, to implement reforms, but there appears to be a consensus forming in the government over the general direction of the economy (Leeb, 2002: 1).

4.4 The PRC's Social Environment

4.4.1 *Unemployment*

One of the most serious problems facing the PRC in the near future will be widespread unemployment (Zhengzhou & Liaoyang, 2002: 1). The PRC's labour force is expected to grow from 742 million in 2000 to 822 million in 2010 (Dahlman & Aubert, 2001). This means that the Chinese economy needs to create about 8 to 9 million new jobs annually for new labour market entrants (Dahlman & Aubert, 2001; ADB, 2002: 3).

The Official registered urban unemployment was 3.6 percent at the end of 2001, up from 3.1 percent at the end of 2000 (BBC, 09/04/2002: 1; World Bank, 2002: 7). However, if the estimated 11 to 12 million laid-off state workers, and the 60% of the population who live in the rural areas were to be included the figure would be much higher (Hansen, 2000: 2; Wingfield-Hayes, 2002: 1). Peking University economist Xiao Zhuoji estimates the urban unemployment rate nationwide at as high as 15%-20% (Zhengzhou & Liaoyang, 2002: 1).

According to statistics, firms under all forms of ownership and in most provinces have been reducing employment (Mukherji & Ogawa, 2001: 5). Even though the government has delayed some reforms to lower unemployment, millions of laid-off state workers are still unemployed and there are concerns that WTO membership will increase competition and subsequently result in further restructuring and unemployment (Hansen, 2000; Kirby, 2001: 1; BBC, 2000: 1; Fewsmith, 2001: 573; BBC, 09/04/2002: 1; Elliott, 2001: 1; BBC, 15/11/1999: 1; World Bank, 09/04/2002: 7). According to the Chinese Academy of Social Sciences approximately one million workers a year are likely to be laid off from state enterprises in the next five years (Hennock, 2001: 1).

In the rural areas unemployment has hit the hardest. The estimated rural unemployment is 120-150 million, and as a result large numbers of migrants have already flooded into the PRC's cities. By the year 2005 approximately 50 million rural people (8 to 10 million a year) are expected to migrate to urban cities in search of work (Hennock, 2001: 1; Wingfield-Hayes, 2002: 1). In the larger cities like Beijing, and Shanghai the floating population is already roughly 30-40 percent of the populace (Leyden, 2001: 1).

The result of job losses could lead to widespread protests and social unrest. The laid-off state workers could be expected to be especially hostile. In the 1990's they generally had relatively good incomes, job security, fringe benefits and subsidies, and were in general well looked after by the government (Whyte, 2000: 1). Now, many of them have not only lost their jobs, but the 'iron rice bowl' benefits such as housing, medical care, schooling and even pensions have been either weakened or eliminated (Whyte, 2000: 1; East Asia Branch, 2002: 9; ADB, 1996: 8).

Given these trends it is understandable that labour-related strikes and clashes in different parts of the country have escalated in recent years (BBC, 28/06/2002: 1; Zhengzhou & Liaoyang, 2002: 1). Tens of thousands of laid-off workers have demanded jobs, pensions, economic relief, the right to organise their own labour unions, and to remonstrate against the closure of factories (CNN, 13/03/2002: 1; Zhengzhou & Liaoyang, 2002: 1). Some workers have even demanded the release of their leaders detained by police and the sacking of corrupt and callous government officials (Zhengzhou & Liaoyang, 2002: 1).

What is worrying to the Chinese government is that workers are now staging joint actions. Their labour protests are better organised, in many cases by underground trade unions, and workers seem unintimidated despite official coercion (Wo Lap Lam, 27/03/2002). In the most recent conflicts the government has used the defence forces (PLA and PAP) to crush labour unrest and safeguard social stability (Wo Lap Lam, 27/03/2002). Instead of attempting genuine reforms to improve the welfare of laid-off state workers and rural dwellers and to resolve the country's mounting contradictions it seems as if the leadership has decided to rely on the "tools of the dictatorship of the proletariat" (Wo Lap Lam, 27/03/2002).

Unemployment is likely to rise now that the PRC has joined the WTO as many less competitive industries and SOEs face collapse and millions of farmers are expected to be driven out of business by competition from cheap agricultural imports (Wingfield-Hayes, 2002: 1; CNN, 05/03/2002: 1). Competitive pressure will be strongest in the sectors such as agriculture, automobiles, banking, insurance, telecommunications and pharmaceuticals (BBC, 2000: 1; China Daily, 2002: 1; Fewsmith, 2001: 573; BBC, 19/04/2002: 1).

4.4.2 *Poverty*

According to the PRC's official figures, the number in poverty has dropped from 30.7% of the rural population in 1978 to 4.6% in 1998 (Schiffes, 1999: 2). The World Bank figures, however, are less optimistic by putting the number of rural poor at 13.5% of the population (Schiffes, 1999: 2).

Chinese people's incomes in general have been steadily increasing, and households in all income groups have benefited from growth (www.china.org.cn; Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 10). However, households in the top decile enjoy nearly 8 times higher growth rates in their income, compared to the bottom income decile (Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 10). For example, during 1998-2000, the growth in income of poor urban households was 2.7 percent, whereas the growth in income of the top decile was 9.7 percent (Brixi, Hau, Liu, Scott, Szeto & Zhang, 2001: 10).

Rural areas have also experienced the benefits of rapid economic growth and poverty reduction. The rural poor population decreased from 31% of total rural population in 1978 to 3% in 2000 (Sangui Wang, 2002: 1). However, this does not mean an end to rural distress, which is widespread, nor does it mean that rural-urban inequality is narrowing. The agricultural sector suffers from rising costs, falling output prices, and different kinds of taxes, levies and other illegal charges imposed by local officials (Wo Lap Lam, 27/03/2002: 1; Lu Xueyi, 2000: 1; Mukherji & Ogawa, 2001: 3; Whyte, 2000: 1). There are also wide differences in policies applied to urban and rural populations (Lu Xueyi, 2000: 1). These range from ownership, distribution, circulation, employment and taxation to education, medical care, labor insurance and pensions (Lu Xueyi, 2000: 1). Also, Chinese agriculture is inefficient and highly vulnerable to global markets (Zweig, 2001: 241). In agricultural production the PRC has comparative advantage in only live hogs; all other products are above international prices (Zweig, 2001: 241).

4.4.3 *Increasing Regional Inequality*

In addition, another economic debilitating problem for the Chinese Government in the future will be the income inequality, highlighted by the widening gap between the rich coastal areas and the poor interior provinces (Hansen, 2000: 3; Lardy, 2002: 1; Lu Xueyi, 2000: 1).

The coastal regions of the PRC enjoy fertile soil, close proximity to the coast, several large industrial centers, and a developed infrastructure (Schifferes, 1999: 2). Consequently, the coastal regions have attracted large amounts of foreign investment over the past decades (Schifferes, 1999: 2). The interior of the PRC, however, is barren, undeveloped and beleaguered by poverty. Income in the interior provinces is only 65 percent of national average (Hansen, 2000: 3). As a result, the gap between regions has dramatically increased. The PRC has gone from being one of the most equal income distributions in the developing world to one of the most unequal (Schifferes, 1999: 3; Lardy, 2002: 1; Whyte, 2000: 1). The rise of regional inequalities have resulted in the deterioration of social services, especially education and health care, migration from inland regions to the coastal regions, and an overall feeling of dissatisfaction (Lau, 2001: 26).

In order to sustain national annual GDP growth of at least 7 percent, the Chinese government has begun to promote the development of the interior provinces (Hansen, 2000: 3). The PRC is currently investing government funds in the area, taking measures to attract foreign investors to the interior of the PRC, and implementing its Great Western Development Project (Hansen, 2000: 3). The area presents an attractive potential opportunity for businesses as the Chinese government is offering cheap land and tax breaks for companies locating in that region (Hansen, 2000: 3). However, transportation costs and corruption have precluded many companies from building factories there (Hansen, 2000: 3).

4.4.4 *Health*

The PRC's health sector is facing the burden of infectious diseases such as tuberculosis, HIV/AIDS and sexually transmitted infections (STIs), and other non-infectious diseases due to changing lifestyles, dietary habits, and smoking (World Bank, 2002: 8).

Tuberculosis is the number one infectious disease in the PRC, with over 400 million persons infected and five million people with active disease (World Bank, 2002: 8). As a result, 1.3 million additional persons become infected and 150 000 die each year (World Bank, 2002: 8).

The total number of HIV cases in the PRC now exceeds 1.5 million according to the UN Programme on Aids (UNAids) (World Bank, 2002: 8; BBC, 27/06/2002: 1). The agency estimates that unless rapid measures are taken, the number of infected people in the PRC could reach 10 million by 2010 (BBC, 17/06/2002: 1).

The increasing inequalities in access to health, education, and essential public services especially in the rural areas complicate the human development challenge in the PRC (World Bank, 2002: 8). The main reason for the inequality is that regional disparities in fiscal spending are skewed. Local governments in poor areas are at the lower end of the distribution and receive far less funds for social expenditure than local governments in coastal areas and big cities (World Bank, 2002: 8). Altogether less than a third of the PRC's health spending goes to the rural areas, where 70% of population live (BBC, 04/07/2002: 1). The World Health Report 2000, indeed, ranked the PRC 188th in terms of fairness in financial contribution (World Bank, 2002; 8).

4.4.5 Organized Crime

The PRC is also facing an increasing problem of organized crime groups that have a hand in such activities as illegal gambling, extortion, drug trafficking, gun-running, smuggling, prostitution, illegal immigration, fraud and the manufacture and sale of pirated goods (Craig, 1997: 1). An estimated one million Chinese are engaged in organised criminal activities, many with international connections and operations (Craig, 2001: 3). Authorities at various levels have also been implicated in these criminal activities (Craig, 2001: 3).

The PRC has admitted that the situation on cross-border organized crime has grown increasingly serious, and announced its intention to crack down on criminal activity, which is believed to be a threat to the social stability in the country. The PRC has also stated that international cooperation to fight against crime is needed.

4.4.6 Environmental Problems

Rapid industrialisation and urbanisation, as well as the use of chemical fertilizers in the agricultural sector have caused serious environmental damage over the past twenty years (Hunter & Sexton, 1999: 2). As a result, soil degradation, deforestation, desertification, water pollution, and depletion of water reserves and other natural resources are among many severe problems that are threatening the economy and the people of the PRC.

Although measures has been taken to revert the process of environmental degradation, environmental problems are increasingly worrying to public health and the state of the economy. According to statistics an estimated 2 million people die each year from air and

water pollution (Dahlman & Aubert, 2001: 4). Over half of the population lacks access to clean water, and overall only 5 percent of household waste and about 17 percent of industrial waste receive any treatment before returning to nature (World Resources Institute, 2002: 1). Air pollution in some Chinese cities is more than ten times higher than the standard proposed by the World Health Organization (World Resources Institute, 2002: 1). In recent years, natural disaster such as dust clouds, sandstorms, floods and sandslides have also caused a great deal of destruction and resulted in loss of lives (Plausible Futures, 2002: 6).

As demands for water from industries, households, and farming communities are rapidly increasing alongside industrialization and an increase in agricultural production, especially in animal husbandry, water reserves are being severely exhausted. In recent years, droughts and floods have already caused havoc in the PRC. Population growth, changing consumer patterns, loss of land due to urbanization are also factors that could lead to instability and food shortages in the future.

4.5 Conclusion

This chapter has presented the current economic, political and social developments, trends and driving forces affecting the PRC's investment environment. The review of the PRC's investment environment will help in the construction of four 'The PRC 2022' scenarios in the next chapter. The trends that are likely to impact future foreign investment in the PRC include increasing poverty, income disparity, unemployment, labour force stability, economic growth, government actions and policies, changes in leadership, openness of political system, military capacity, efficiency of legal and banking systems, and occurrence of ethnic and religious conflicts, to name a few.

CHAPTER 5

Political Risk Analysis on the PRC

5.1 Introduction

This chapter will apply the six steps of scenario planning, introduced in the fourth chapter, to the case study on political risks in the PRC. Four 20-year scenarios will be constructed around four possible paired combinations of the following critical uncertainties: economic growth/slowdown, and democratic/authoritarian governance. The process will start with the identification and analysis of key organisational decisions that will provide the focus for the scenarios, and concludes with the analysis and interpretation of the scenarios for their decision implications. The chapter will include a set of long-term recommendations and strategies for managing political risk that would best advance foreign investors in the future the PRC.

5.2 Step I: Identification and Analysis of the Organizational Issues That Will Provide the Decision Focus

The starting point for the scenario development process is the very specific decisions or questions that confront organisations and determine the purpose of scenarios (Business Futures, 1997; Morrison & Wilson, 1997: 1; Flower, 1997: 1; Fein, 2002: 1; Kleiner, 1999; Wilkinson, 2002: 1; NATO, 2002: 1; Analysys, 2002: 1; Schwartz & Ogilvy, 1998: 59; Ringland, 1998: 77; Wilson, 1998: 84; Fahey, 1998: 192; Wack in Wilson, 1998: 355; Swartz, 1999: 241; Rossiter & Karplus & Jones, 1986: 137; South Wind Design, 2001: 1; MetaBridge, 1996: 1).

In this case study the key questions that confront foreign investors planning to do business in the PRC are the following:

- What are the potential political risks foreign investors or business people will face in the future PRC?
- What are the alternative futures for foreign investment and trade in the PRC?
- Is there potential that the political risks will surpass the investment or business benefits?
- Under what conditions will political risks be greater than investment or business benefits?

- What will be the best methods of managing political risk in the future PRC?

Besides determining the decision focus for scenarios, the first step also involves selecting a time frame for the scenarios and the number of scenarios (Kleiner, 1999; Bain & Company, 2002: 1; Swartz & Ogilvy, 1998: 59).

This case study will generate four 20-year scenarios, and draw implications and policy insights for foreign investors planning to do business in the PRC.

5.3 Step II: Specification of the Key Decision Factors

The second step of scenario development entails identifying the key decision factors that decision-makers need to know about the future in order to make their decisions since the key decision factors will influence the success or failure of the venture (Morrison & Wilson, 1997: 1; Wilson, 1995; Ringland, 1998: 229).

Decision factors for foreign investors that will influence the success or failure of their decisions to some degree in the future PRC include the following:

- Internal and external political stability/instability: government actions and policies, changes in leadership, openness of political system, military unrest, legal environment, corruption, etc.
- Social stability/instability: ethnic and religious conflicts, unemployment, poverty, urbanization, income disparity, labor force, etc.
- Economic stability/instability: GDP, economic growth rate, interest rates, terms of trade, macro and micro economic policies, efficient banking and financial systems, level of state intervention, infrastructure, etc.
- Investment environment: openness to trade and investment, competitiveness, technological trends, consumer trends, market forces, etc.
- The global economy and globalization: global developments such as worldwide inflation, recession, oil crisis, and global organization's actions and policies, foreign policies of other countries, etc.
- Environmental stability/instability: rate of pollution and environmental degradation, water and land resources, natural disasters, etc.

5.4 Step III: Identification and Analysis of the Key Environmental Forces

The third step involves the identification and analysis of the key micro and macro environmental forces: both predetermined environmental forces and critical uncertainties.

The PRC specialists in various disciplines agree that there are a number of predetermined driving forces - developments that almost certainly will shape the PRC's future. Population is expected to grow, and become more urbanized (CNN, 1999: 1; <http://mars3.gps.caltech.edu>). As a result, water, food, and energy consumption will increase (CNN, 1999: 1). Restructuring of the economy and global competition are expected to lead to rising unemployment (CNN, 1999: 1; <http://mars3.gps.caltech.edu>). Environmental degradation is expected to increase due to rapid modernization (<http://mars3.gps.caltech.edu>). Some would say that the economy could be expected to grow, although the pace of economic growth is difficult to determine (Leeb, 2002: 1; Leyden, 2001: 1).

The second set of driving forces consists of key uncertainties that cannot be confidently determined in advance. The key uncertainties in this case study include factors such as government actions and policies, changes in leadership, openness of political system, military capacity, efficiency of the legal system, the rate of corruption, possible occurrence of ethnic and religious conflicts, income disparity, labour force stability, efficiency of banking and financial system and the overall state of the economic environment. The trends and forces affecting the investment environment or the global environment are also hard to determine in advance.

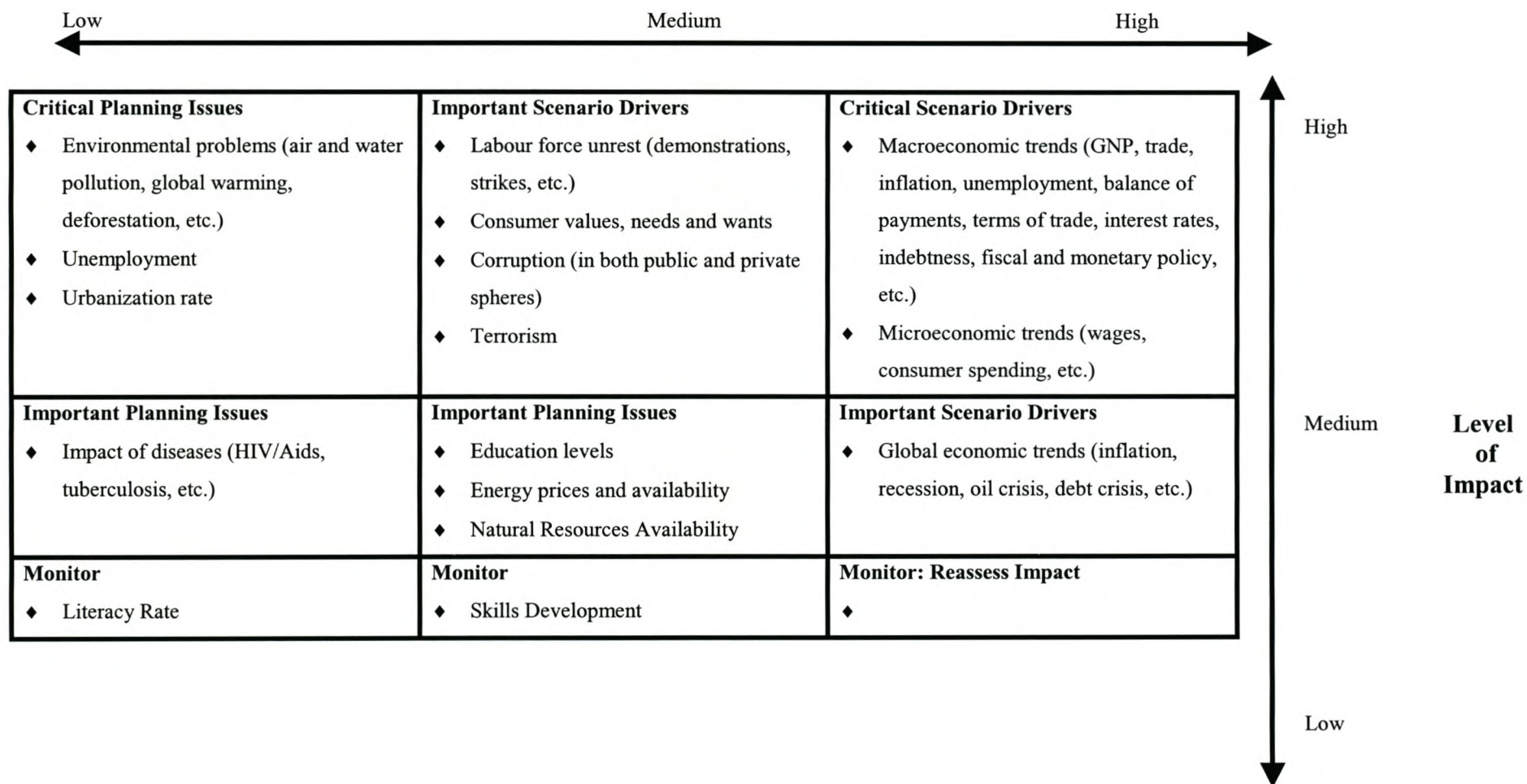
At this stage, in order to be certain of which driving forces are truly uncertain and critical a systematic sorting process such as an impact/uncertainty matrix is often applied (Wilson, 1998: 88; Morrison & Wilson, 1997: 1; Jennings & Wattam, 1998: 179).

In this case study the impact/uncertainty matrix includes a number of driving forces, illustrated in the graph 4.

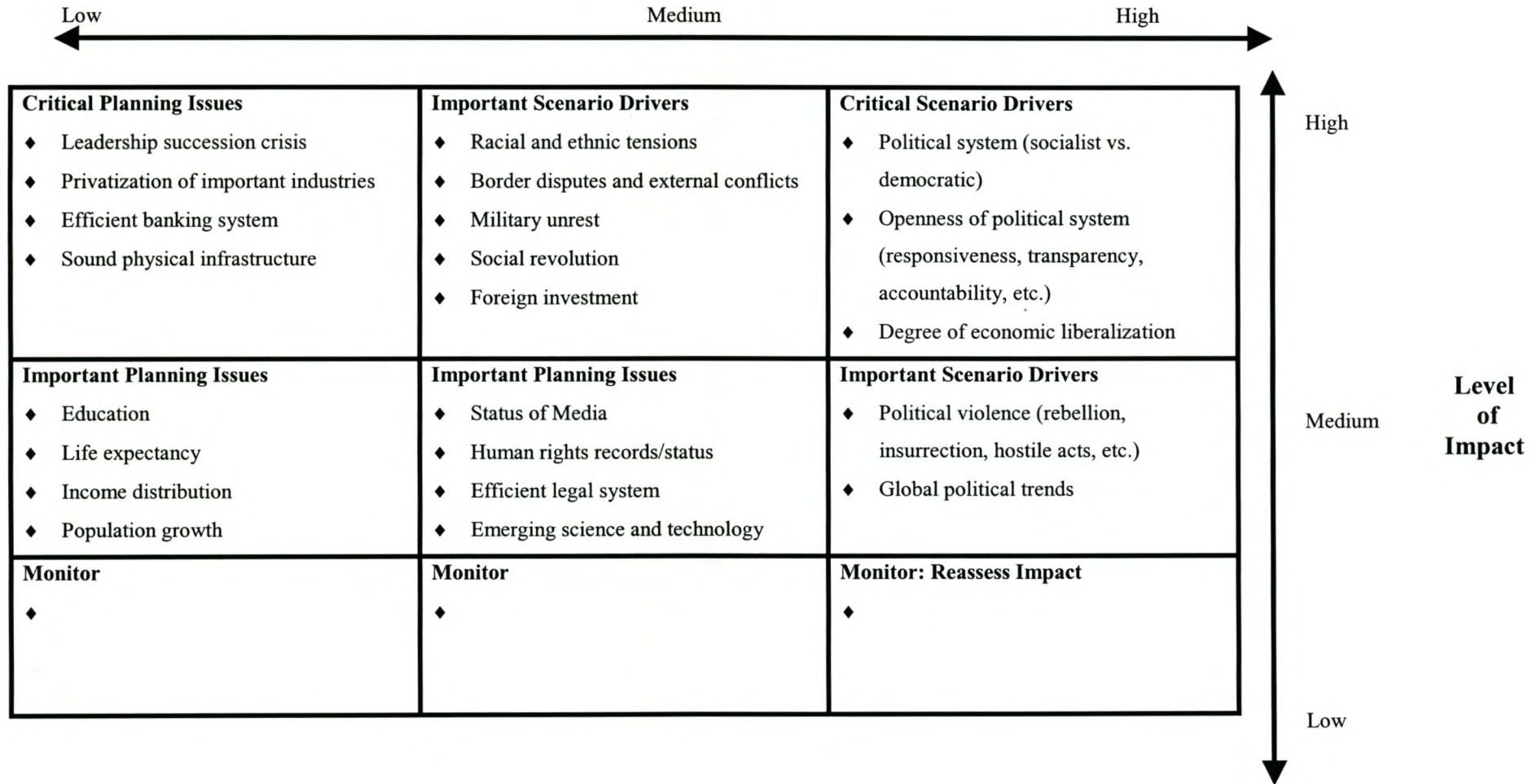
Graph 4.

Impact/Uncertainty Matrix

Degree of Uncertainty



Degree of Uncertainty



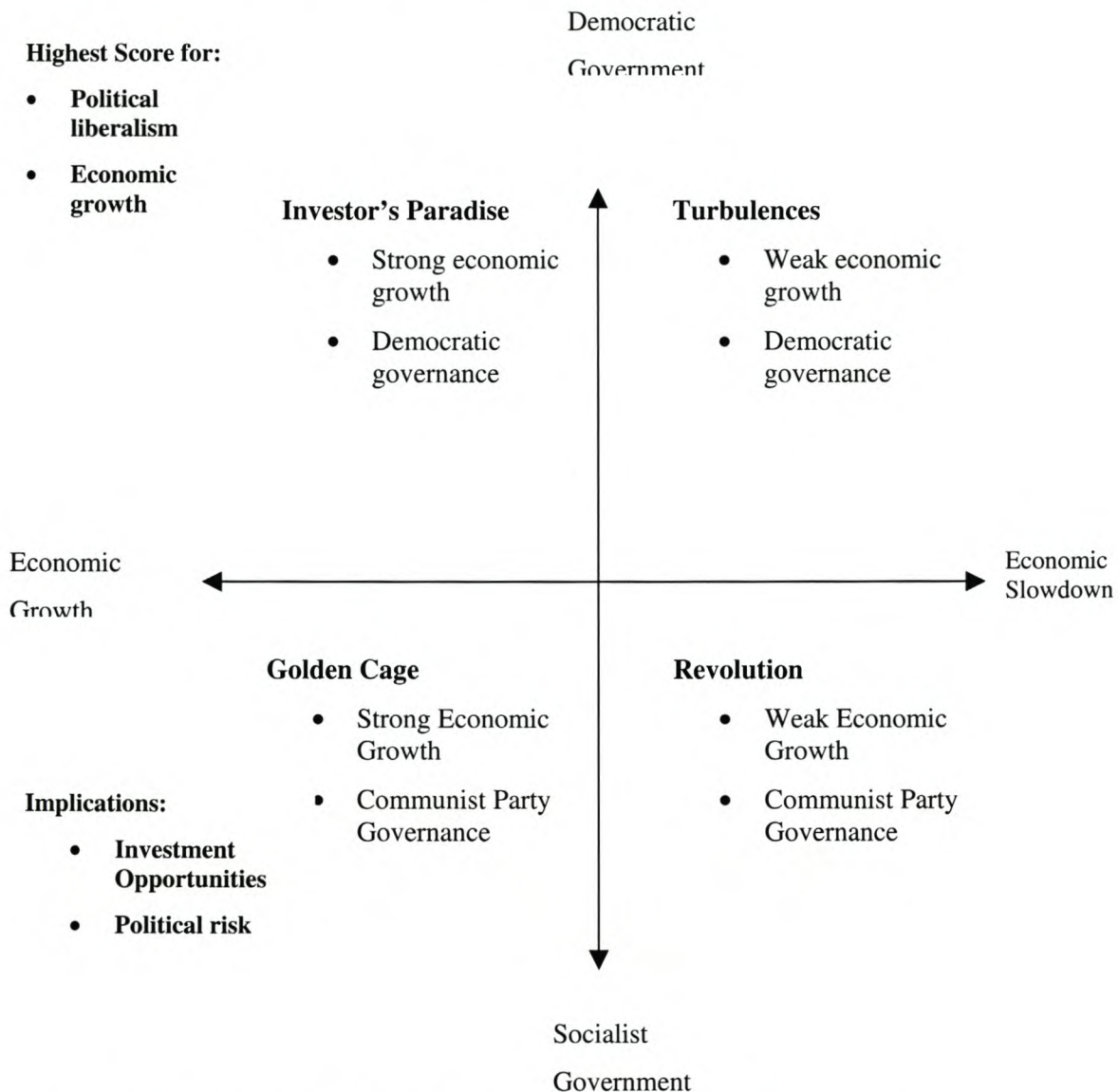
5.5 Step IV: The Selection of the Scenario Logics

The fourth step of scenario planning entails the establishment of the scenario logics – “the organizing principles around which the scenarios are structured” (Morrison & Wilson, 1997: 1; Ringland, 1998: 82). In other words, the aim is to develop a logical, in-depth rationale and structure for the selected scenarios (Wilson, 1998: 89; Fahey, 1998: 209; Morrison & Wilson, 1997: 1).

A practical tool at this stage is a scenario matrix. The two critical uncertainties that this scenario matrix attempts to explore are: (1) Whether the PRC’s political environment will remain in the control of the Communist Party and as such authoritarian, or change into a democratic system of governance; and (2) whether the PRC will sustain high economic growth (above 4%), or will either experience a slow economic growth (below 4%) or perhaps slide into recession in the future. The scenarios developed on the basis of the scenario matrix (Graph 5) will be one of the four possible paired combinations of the two critical uncertainties.

Graph 5

The Future Developments in The PRC



Source: Adapted from Schwartz & Ogilvy, 1998: 65; Morrison & Wilson, 1997: 1

5.6 Step V: Selection and Elaboration of the Scenarios

As the scenario matrix illustrates this case study investigates the PRC's future in terms of economic growth/slowdown, and political stability/instability in terms of democratic or authoritarian governance. A sustainable growing economy and political stability are necessities for the PRC's future stability. The growth sustainability of the Chinese economy depends essentially on its continued commitment to institutional reform and economic deregulation. The future political stability, on the other hand, is believed to be dependent on the rate of political liberalisation.

The four scenarios developed in this case study will illustrate four possible futures for the PRC. The first scenario, 'Investor's Paradise', will present a picture of an economically viable and democratic the PRC in year 2022. The second scenario, 'Turbulences', will portray the PRC as a country troubled with a weak economy and a struggling democracy. In the third scenario, 'Golden Cage', the PRC's political system remains the same, coupled with high economic growth. And the last scenario, "Revolution", will depict a story of the PRC under tightening authoritarian rule and the pressures of a weak economy.¹

5.6.1 *Scenario I: Investor' Paradise*

It is the year 2022. The last twenty years have witnessed gradual, yet significant changes in the PRC. The country is now one of the world's leading nations, with the second largest economy and military power, as well as the world's largest consumer market with the population of 1.6 billion.

The economic growth has been phenomenal. The annual economic growth has been 8 % between 2002 and 2022. This has been possible due to high annual savings rate of 40%, high productivity growth of 2% per year, and continuing inflows of foreign investment. Personal incomes have increased at such a rate that they are now as high as in the rest of the Asian economies.

The changes have occurred gradually following the PRC's entry to the WTO coupled with the government's dedication to economic deregulation, decentralisation, free trade policies and the upliftment of the living standards of the Chinese people.

The pressures for political reforms began at the beginning of the century. As prosperity spread the rising middle class began to demand an improved social system, and political freedoms. The government found it increasingly difficult to maintain the control of the country by traditional means. Increased flow of information, capital, goods, services, and people challenged the authority of the government, and created demands for greater democratisation and transparency. The international community and foreign investors in the country also began to call for a more consistent legal system, a tougher stance on corruption and crime, and increased international cooperation in terms of reducing environmental degradation,

¹ The scenarios constructed in this study were inspired by trends, driving forces and scenarios found in the following sources: Keng, 2001; CSBA Online, 2002; <http://mars3.gps.caltech.edu>, 2002; CNN Online, 1999; National Intelligence Council, 2000

protecting intellectual rights, among others. Economic reforms, including privatisation of SOEs, the inflow of foreign multinational firms, and the removal of trade barriers, eventually reduced the state's role in the economy, and thus eroded the power of the ruling party. The Communist Party was ultimately forced to undertake political reforms, and to create more democratic constitution.

Although the first democratic government was led by a single party dominance (the Communist Party), it was incredibly successful in reforming the country. Besides economic reforms, the government accelerated the pace of institutional reforms, and relaxed most of its central government intervention in provincial economic affairs. The government also developed policies that encourage private business sector empowerment; transparency in government and the efficient delivery of public services; and the of maintaining institutions to control illegal criminal activity. The government has implemented favourable policies towards ethnic and religious minorities, and promoted economic development.

Since 2002 the government's role in the society has shrunk significantly. The majority of state-owned enterprises have now been successfully transferred to the private sector, and most of the government's functions are performed by public-private partnerships. The number of multinational corporations has increased dramatically in recent years. Foreign investors have continued to pour into the country as a result of a gradual reduction in tariffs, and improved business climate.

Over the years the banking system has been modernised and broadened. The legal and judicial systems are now more transparent and predictable. New and efficient tax systems have enabled urban areas to construct housing, roads, and sewage systems to cope with the 'floating' population. The government's infrastructure projects and the construction boom in the private sector has absorbed many of the laid-off industrial workers and rural people over the years.

Decentralised, and relatively autonomous regional governing bodies have emerged over the years. This has fuelled both competition and cooperation among the regions. As a result, internationally competitive regional markets and industries have sprung up, the PRC's economy has grown as a whole, foreign investment has accelerated, and Taiwan and Hong Kong are now considering economic integration with the PRC. If Taiwan and Hong Kong

were to integrate the PRC would further benefit from among others, new technology, skills, capital, management skills and know-how, international expertise.

Technological advances in science and technology have been utilized effectively in different fields. The use of genetically modified crops has to a greater or lesser extent met the nutrition needs of the country's poor. The threat of water shortages has been overcome by such government measures as using water more efficiently, developing genetically modified crops that use less water, and importing water. The PRC's willingness to implement international agreements (The Kyoto Protocol on Climate Change and the Montreal Protocol) to restore the stratospheric ozone layer, to control the worldwide spread of persistent organic chemicals and dioxins, and to reduce the rate of increase in the amount of pollution produced, has improved the quality of air and water substantially over the past twenty years. The government has also encouraged the use of fuel cells and hybrid engines, the utilization of solar and wind power, and a shift toward less polluting fuels, such as natural gas.

In the meanwhile, the Chinese have been investing actively abroad, secured their international sources of energy and raw materials, and sustained international markets for their products and services. The global business environment has been favourable - there has not been any major conflicts or impediments in the international trade and investment environment. In order to meet the conditions needed for effective information technology utilization the PRC has also invested vast amounts of capital in technology, education, and infrastructure, and legislated appropriate regulatory policies.

Today, the PRC is a leading military power in the world. Throughout the past twenty years the PRC has acted responsibly, cooperative, and promoted mutually beneficial activities both regionally and internationally. The PRC's leadership realized at the beginning of the century that in order to achieve economic modernization and enjoy the benefits of free trade the PRC would need to work within the framework of the international system. Since then the PRC has sought to avoid conflict in the region in order to promote stable economic growth and to ensure internal stability.

Despite increasing wealth and prosperity, the PRC's future will experience its share of challenges. First of all, declining birthrates and a large aging population are expected to increase health care and pension costs. In addition, declining birthrates are likely to leave

significant shortfalls in the size and capacity of the work force, and strain social services, pensions, and health systems.

Another major problem is the rising number of immigrants. Over the past twenty years, the PRC's prosperity has attracted large numbers of both legal and illegal immigrants from neighboring countries. Recently, incidents of ethnically related violence have been increasing in the country's largest cities. The number of ethnic incidents is expected to grow substantially and to increase social and political tensions.

5.6.2 *Scenario II: Turbulences*

The beginning of the 21st century marked a new beginning for the PRC. In the end of 2001 the PRC joined the WTO, and two years later the old leadership was replaced by a group of young and capable successors, determined to follow the path of economic liberalization.

As prosperity spread the need for improved social systems, political freedoms, and greater liberalization intensified. In addition, economic reforms, including privatization of SOEs, the inflow of foreign multinational firms, increased international cooperation, and the removal of trade barriers, eventually began to reduce the state's role in the economy, and erode the power of the Communist party. The government first expanded the range of local elections in villages and urban areas, resulting in a shift of power to elected officials. Reforms were led by open-minded young leaders in the Party. Political reforms gradually led to the democratization of the government.

The Communist Party won the first elections and continued to dominate as a single ruling party. Although the new government was democratically elected, the style of political governance was not much affected. Personal loyalties, lines of authority, and connections with the military and business sectors still often influenced decisions. Corruption and nepotism were still rife in political ranks.

The problems that had threatened political and social stability in the country before the democracy continued to trouble the new government. Unemployment, growing inequality, migration to urban areas, environmental degradation, and water and food shortages soon became the stumbling blocks for the new government. These problems were also the major causes of increasing criminal activity in the country.

The PRC had always had a reputaton for high rates of crime and corruption. However, since the PRC's accession to the WTO, criminal organizations had been spreading at a rapid pace. Mostly due to advanced information technology, better transportation networks, and openness to the outside world criminal elements in the society were able to expand the scale and scope of their activities. They formed alliances with one another, and infiltrated their influence into the government's leading ranks. The banking system and the stock market has been especially badly affected by corruption. The PRC's banks and the stock market have become a lucrative sphere for the crime syndicates, unregulated and easily manipulated by people on the inside.

Today, the criminal networks of influence cover a wide spectrum of both political and economic institutions and businesses. Some organized crime syndicates cooperate with rebellious political movements and control substantial geographic areas. In some areas of the country the illegal factions have the support of the local people for the reasons that these factions have been able to provide services such as health clinics and schools in the region, unlike the corrupt local government authorities.

The activities and operations of these crime syndicates include narcotics trafficking, trafficking an illegal immigrants, women and children, smuggling toxic materials, hazardous wastes, illicit arms, military technologies, as well as other illegal goods, financial fraud, pirating videos, CDs, software, and other commodities. Some of the crime syndicates have even been able to produce or acquire more sophisticated weaponry, even weapons of mass destruction and biological weapons - according to some sources.

As a result of the rise in criminal activity the strong economic growth of the beginning of the century has given way to a much slower economic growth, reduced foreign investment, and lower profits for those that had decided to stay. The PRC's future looks uncertain.

5.6.3 *Scenario III: Golden Gage*

The 21st century started with great hopes and acclamations. The PRC's entry into the WTO was seen as a promise of continuing economic growth, and the government's commitment to a wide range of reforms as the first step towards democracy in the country.

However, although committed to economic liberalization, the new leadership, elected in 2003, was not willing to undertake a dramatic shift from Communist ideology to liberal political principles. The communist party retained its hold on political power.

The government, however, took a number of steps to strengthen civil society and participation in the political arena since the country's accession to the WTO. A number of significant partnerships were created between the government and the business sector. As a result, the business sector was able to alleviate, although not completely resolve, some of the critical problems, including water shortages, degradation of arable land, and low productivity of the agricultural sector.

The government was also able to create an efficient legal system, reducing crime and corruption, and an effective tax system that made resources available to social projects and infrastructure development. The majority of government-owned enterprises were either restructured or switched over to the private sector. Favorable investment climate for national and foreign businesses were maintained, and consequently FDI continued to pour into the country. In addition, although political democracy was promoted the policies adopted by the government considerably improved human rights and environmental protection in the country.

Although the US and the PRC have had a high level of economic integration over the years, the relations between the two nations have remained somewhat spurious. The US has always feared that the PRC has global intentions, and thus poses a threat to regional stability. Additionally, there are a number of other issues that have led to increased competition and suspicion over the years.

First of all, the US' deployment of the National and Theater Missile Defense (NMD and TMD) defense systems in Japan and Taiwan in 2010 undermined overall US-the PRC relations and created a volatile security environment.

Secondly, the strong growth of the PRC's economy, especially the low-cost manufacturing sector, has angered many Americans, who blame Chinese imports and the influx of US investment to the PRC for their own economic hardships - rising unemployment, economic uncertainty, and so on. As a result, anti-free trade and anti-globalization movements in the US have considerably strengthened over the years. Many US and other foreign companies,

especially in Latin America and East Asia, have raised the strong opinion that the PRC was the main cause of displacement of production and of market share from their economies.

Finally, although the Chinese government has taken a more relaxed stance on the issues such as human rights, political freedom, religions rights, unfair labor practices, and environmental protection - these issues has continued to be major sources of disagreement between the two countries.

The US was quite right to believe that the PRC had much broader military intentions. Over the years the impressive economic growth has fuelled national desire to see the PRC not only powerful economically but strong militarily – to exert influence, to promote and protect its interest, to outmatch its neighbouring countries and to constrain US power in the region. Although the PRC have been promoting mutually beneficial relations with its neighbours the PRC has also been developing means to execute its influence through coercive measures, if necessary. Since the beginning of the century the PRC has developed and improved a series of policy levers (diplomatic, economic, military) that now give it the capability to act as a regional hegemonic power. The Chinese government has also been rapidly modernising and increasing its military capabilities, and as a result the military force is now larger and more advanced than it was twenty years ago; capable of conducting a wide range of operations.

To oust the US dominance the Chinese government has also been actively seeking regional allies in order to maintain a peaceful security environment, and has even suggested that a regional security regime should be developed. Bilateral relations between the PRC and Japan have significantly improved since the two countries reached an understanding on several long-standing disputes. To counter US dominance the PRC has also nurtured links with Russia, as well as, forged greater political and economic links with its neighbouring countries over the years.

Political and social instability began to build up in the beginning of 2021 as the PRC's leadership expressed its intention to re-unite Taiwan with the mainland. Reunification of Taiwan had always been a part of the PRC's plans. However, previously the PRC had had neither capital nor the necessary military power to take over Taiwan. In addition, twenty years earlier resistance in Taiwan in terms of the PRC's "one country, two systems" policy had been much stronger. Since then approximately 20% of the Taiwanese population have migrated to the Mainland the PRC, largely because of increased business opportunities. As a

result, many of the Taiwanese migrants are now supportive of the government's plans to reunite the two systems. Similarly, the majority of the Chinese believe that Taiwan does belong to the PRC and should be reunited with the Mainland.

The majority of Chinese have accepted the political status quo as their lives in general have improved dramatically over the years due to strong economic growth. Most Chinese have little interest in politics or inclination to take risks to press for political changes. Most focus their attention on economic and career endeavours. They are content as long as the leading party remains unified and the economy continue to grow. Many Chinese, however, are legitimately concerned that internal conflicts, stemming from religious, ethnic, economic or political disputes, may increase in the future. The general sentiment in the country is nationalistic, and the US dominance in the world affairs is perceived negatively. As a result, many Chinese are quite willing to support the government's tough stance to discourage or suppress any internal political and social dissonance and those critical of government policies, and to side with government's position in internal affairs.

As the news of the PRC's plans to reclaim Taiwan broke the US was to say the least agitated. In response, the US issued a warning declaring that it would do anything in its power to put a stop to the PRC's illegitimate plans to take over Taiwan. The US began to rally for international support for its plans to take the necessary (military) action to defend the democratic rule of governance, and to root out the 'evil' communist regime that was against basic human rights and political freedom.

To strike back at the PRC's intension for regional dominance the US government also took action by deploying a national missile defense system and supplying advanced military weaponry to Taiwan and a number of other allies in the region. The Chinese government, however, viewed the deployment of missile defense as an increase in hostility. The crisis soon led to a break in economic and other constructive US- the PRC relations, resulting in a stand off.

The problem with the US, however, was not the only difficulty the PRC was facing. As the conflict escalated with the US, ethnically, religiously, and politically motivated social unrest around the country began to surface. Political opponents, ethnic, and religious minorities has always been a problem to the Chinese government. Although the government have been successful in creating a functioning economy, it has not been able to control the brewing

discontent, or shape to its advantage the content of information due to rapid developments in information technology and the growing number of Internet users. As a result, the ethnically, religiously, or politically motivated opponents of the government have been able to spread their message, recruit new members, and gain international support for their causes. For instance, a large Muslim separatist movement in the Xinjiang Uighur Region has been preparing to fight for independence or self-autonomy for years. What has been beneficial to this Muslim population is that it is geostrategically well-situated close to other Muslim states, and has been able to maintain friendly ties with other Muslims in Central Asia and the Middle East.

To this day, the hostilities between US-the PRC are deadlocked. The PRC has confirmed that it will put an end to the Taiwan situation as soon as the internal conflicts have been resolved. The Chinese government is not expected to give up its power, especially in Xinjiang region as most of the PRC's oil reserves and nuclear power resources as well as large gas, iron, and coal deposits, are located in Xinjiang. The continuing internal conflict is, however, eroding the PRC's reputation among the international community. The government's crackdowns of internal rebellions are viewed as violations against basic human rights. The Western world is particularly concerned about the PRC's future, and foreign investors and business people fear that the hostilities will lead to the war. The future of the PRC looks uncertain.

5.6.4 *Scenario IV: The Revolution*

During the past twenty years the PRC has witnessed a major internal conflict. The events leading to the internal crisis began towards the end of 2001 just as the PRC's entered the WTO, and made a commitment to follow liberal trade policies and carry out a number of internal reforms, including downsizing and restructuring the inefficient SOEs, improving both the legal system and the banking sector, and modernizing the agricultural sector. Although the Chinese government was willing to undertake economic liberalization, it was reluctant to relax the Communist Party's political control and engage in political reforms which would lead to more democratic governance.

Despite its best endeavors, the Chinese government was unable solve the problems of unemployment, unequal income distribution, poverty, crime and corruption that were threatened the country's economy at the time. The government was unable to improve the living standards of hundreds of millions of rural people and laid-off workers, and to

implement the necessary reforms in the social welfare system. The government's attempts to bridge the gap between the wealthy coastal regions and the poor interior also failed. Income inequalities grew rapidly over the years. The new, wealthy class of entrepreneurs, professionals and political elite prospered, but the majority of population failed to benefit from trade liberalization. In addition, the heightened competition from foreign corporations, government's persistent efforts to restructure the SOEs and to modernize the agricultural sector, further aggravated social problems. In order to restore stability in the country the government attempted to reverse some reforms (privatization of SOEs), however, this did not bear the expected results. The foreign investors, particularly, began to worry about the PRC's future prospects as well as political and social stability.

Simultaneously, growing pollution, environmental degradation due to intensive land use, and natural catastrophes in rural areas made farming a nearly futile activity. Water shortages in Northern the PRC, which was the major grain-producing area, led to the reduced crops and reduced rural incomes. As a consequence, masses of rural people as well as large numbers of laid-off state workers began to flock into the urban areas, hoping to escape poverty, and to find work or better opportunities.

The migration to urban areas rapidly increased. In the beginning of the century, the growing economy and large inflows of foreign investment were still able to provide jobs for the urban migrants. However, in 2005 the global economic slowdown coupled with domestic recession began to take its toll. The government was no longer able to stimulate the investment required to generate jobs. Similarly, although foreign investment was still pouring into the country, the private sector was also unable to keep up with providing for the increasing prospective work force. The growing urban unemployment led to increasing social unrest.

The cities, burdened by the rapid urban growth, were also incapable of providing the services, infrastructure, and social support services to the growing "floating" population. As a result, informal settlement and shantytowns soon developed around the larger cities. Crime and corruption became prevalent order in many of the settlements - beyond the control of the state authorities and local governments. The poor living conditions were exacerbated by increasingly dreadful environmental condition, including polluted water, growing toxic emission, and sand storms, and increasing food prices. The larger cities such as Beijing and Shanghai faced worsening water and air quality problems. Additionally, inadequate health

capacities and spending led to a surge in both infectious and noninfectious diseases. Tuberculosis, malaria, hepatitis, and particularly AIDS continued to increase rapidly.

As established ways of doing things and forms of security provided by socialist institutions before the WTO entry were undermined, many Chinese struggled to cope and to learn how to operate in the new system. The country's leadership was increasingly viewed as self-serving, and power-hungry. Although the government, with the support of the military and security forces, had been able to control and constrain the critical factions of the society for a number of years, underneath the surface the general opinion was anything but positive. The majority of the population was increasingly discontented with the government's policies and actions.

The social unrest began in the Coastal regions of the country where the unemployed and otherwise disgruntled masses began organizing demonstrations, strikes and riots, demanding food, jobs, and cleaner air and water. The first demonstration sparked a series of large-scale anti-government demonstrations calling for new leadership to provide economic stability, and political freedoms.

The government responded by mobilizing the army to ruthlessly disperse the demonstrations. Tightening the grip of the state on society and using repressive measures to enforce political and social stability seemed the only option. The governing elite, who has been enjoying the advantages of economic reforms as well as the privileges of authoritarian rule, were not willing to lose their benefits and privileges without a fight.

The armed forces were able to control the situation for a while, however, the social unrest soon spread to the other parts of the country, and the underground movement to free the country of the autocratic rule began to take more aggressive measures to curb the government's stronghold.

As a result of the political and social unrest foreign investors and foreign corporations began to flee to more peaceful regions, leaving the country's economic growth to slow to a halt. The civil unrest lasted three years, and ended at the beginning of the year. The government has agreed to hold democratic elections next year. The future looks a little bit brighter – at least for now.

5.6.5 *Alternative Scenarios*

The main aim of this case study scenario exercise was not to predict a single future, but to create a range of plausible futures. The four scenarios, developed in this assignment, highlight the interplay of predetermined and uncertain forces that are likely to affect the foreign investment in the PRC in the next 20 years. In any scenario, foreign investors are expected to have some risks and some opportunities.

The trends outlined in this case study are based on the combinations of drivers that can possibly occur over the next 20 years. Nevertheless, the key driving forces could produce trends quite different from the four scenarios described. The range of possible scenarios, developed by various authors, include:

- The PRC, India, and Russia form a strategic alliance in an attempt to counterbalance US and Western influence (National Intelligence Council, 2000: 1).
- The PRC is faced with a military conflict with neighboring countries due to growing resource scarcities such as water and arable land (<http://mars3.gps.caltech.edu>).
- In order to counterbalance job scarcity, and food and water shortages in the Northern Provinces the government encourages large-scale emigration of the Chinese to Siberia to work in the US and Japanese work camps (<http://mars3.gps.caltech.edu>). As a result, a full-blown conflict erupts between the PRC and Russia (<http://mars3.gps.caltech.edu>).
- As a response to sharp hikes in oil prices, the PRC becomes the world's largest manufacturer of solar cells for solar energy. The boom is stimulated by the government's decision to use solar cells in all government projects from public housing to industrial buildings. The solar energy helps to fuel the country's economic growth, solve the environmental problems, and provide inexpensive energy, massive export earnings and employment. (<http://mars3.gps.caltech.edu>).
- The communist party fears to lose its hold on power, and consequently seeks to end the free market economy and bring Taiwan back to its fold (Cato Institute, 2002).
- The government's investment in solar energy and biotechnology is able to resolve the country's resources scarcity and reduce environmental degradation by providing energy and food, massive export earnings, and a major source of employment. As a result, the PRC increases in its self-sufficiency, its economy continues to grow

rapidly, and environmental impact from energy and agriculture is sharply reduced. (<http://mars3.gps.caltech.edu>).

5.7 Step VI: Interpretation of the Scenarios for Their Decision Implications

The last step entails the analysis and interpretation of the scenarios for their decision implications and development of strategies (Wilson, 1998: 92; College of Marin, 2002; Ringland, 1998: 82).

The first question that was asked in the beginning of the chapter was simply “what are the potential political risks foreign investors or business people will face in the future PRC?” As the four scenarios indicate there are a wide variety of potential future risks.

In the social sphere, rising unemployment, poverty, income disparity, crime, ethnic and religious fractions, and urbanisation are major threats to the country’s political, economic and social stability.

Economic factors that are likely to influence foreign investors include overall economic growth, a degree of openness to trade and investment, and the restructuring of the commercial sector (the SOEs, and the banking system).

In the political sphere, the main concerns are the pace of political reforms towards democracy, the level of accountability and transparency in the leading institutions, the PRC’s military intentions, and individual political freedoms.

What are the alternative futures for foreign investment and trade in the PRC? As the scenarios illustrate the prospects for foreign investment can be both positive and negative. If the economy continues to grow strongly, and the government maintains a stable environment and successfully implements the necessary changes foreign investors will reap the desired profits. However, if the problems facing the PRC at the moment further deteriorate foreign investors can expect increased risks, and the possibility of failure.

What are the best methods of managing political risk in the future PRC? In order to confidently proceed with the investment or business plan this question must be considered.

The literature on political risk management gives a wide variety of options. As this case study is not industry-specific, only the general guidelines of political risk management are provided.

The simplest way to manage risk is to avoid investing when political risks in a given country are considered unacceptable (Miller, 1992: 322). For foreign investors already active in the country, avoidance strategy involves exiting through divestment (Miller, 1992: 322). For foreign investors not yet participating in a market, avoidance strategy implies postponement of market entry until the risks decrease to acceptable levels (Miller, 1992: 322).

Political risk can be managed by direct action (Howell, 1994: 6; Howell, 1998: 10). Foreign investors can attempt to change or adjust the arrangements or circumstances of their investment (Howell, 1994: 6). To prevent kidnapping, for instance, a firm can take protective measures by hiring bodyguards or by moving their operations to a safer part of the country (Howell, 1994: 6).

Another way used by foreign investors to manage political risk is to negotiate a better deal with the host country government (Howell, 1994: 6). However, in order to do this a foreign investor often needs to either have personal relations with the necessary authorities and a throughout knowledge of the business environment in a specific country, or an investment plan that will be extremely beneficial to the host country (Howell, 1994:6).

Political risk may also be managed through cooperation responses. Cooperative strategies for managing risk include contracts and agreements with suppliers and buyers, alliances and joint ventures, franchising agreements, and voluntary restraint of competition (Miller, 1992: 323).

Foreign investors may also manage risk by simply seeking to control "important environmental contingencies" (Miller, 1992: 323). This can be achieved by developing alliances within the host country or within the host government, gaining market power, or vertically integrating in order to control input or demand uncertainties (Howell, 1994: 6; Howell, 1998: 10; Miller, 1992: 323). Developing alliances within the host government, however, can be risky in some circumstances. For example, if the host government that a firm has aligned itself with is overthrown or falls into disfavor (Howell, 1994: 6).

Foreign investors also have an option of creating business conditions such that if a government takes an action that adversely affects the performance of a foreign action this

action in turn will have its impact on the economic performance of the country (Akhter & Lusch, 1987: 85). This two-way economic interaction should discourage a government from taking actions that might harm foreign businesses (Akhter & Lusch, 1987: 85). Strategies used by foreign investors to achieve this type of business condition include integration of business activities multinationally, reduced resource commitment, control of resources and output markets, and planned divestiture (Akhter & Lusch, 1987: 85).

Political risk can also be managed by identifying risk elements and developing a system to monitor and evaluate changing conditions of political risk in the host country (Brummestead, 1988: 95). It is also suggested that risk assessment should be integrated within a firm's strategic planning process, and strategies to protect the firm from political risk should be developed prior to the investment venture (Brummestead, 1988: 95).

Political risk insurance, however, is the most common way to manage risk (Howell, 1994: 6). Political risk insurance is easily available in the public and private sectors, and widely used by international investors and businesses (Howell, 1994: 6; Howell, 1998: 10). Private owners, government-sponsored agencies and multilateral organisations, for instance, provide insurance policies that protect foreign investors against risks such as expropriation of assets, civil strife, war, and currency inconvertibility (Miller, 1992: 323).

Considering the options available for foreign investors, how should foreign investors manage risk under the four scenarios developed in this study.

Under the “Investor’s Paradise” scenario foreign investment environment is ideal for reaping large profits. Continuing high economic growth, open economy, large consumer market, and democratic governance endow foreign investors with a wide variety of opportunities. The WTO rules and regulations ensure that foreign investors have an equal access to the PRC’s markets, and are protected against any misconduct. However, under the “Investor’s Paradise” scenario foreign investor must be prepared for increasing competition from both foreign and local rivals. In the long run, as prosperity spreads and education levels rise taking advantage of low-cost manufacturing sector is also going to become more difficult.

Both foreign and domestic investment depends on the quality of the host country’s business environment (World Bank, 2002: 1). Under the “Turbulences” scenario high rates of crime and corruption erodes the rule of law, and as a result affects negatively foreign investors in a

number of ways (World Bank, 2002: 1). Corruption reduces government revenue, thus reducing the government's capability of investing in education, health, infrastructure, and damaging the country's social and economic development (World Bank, 2002: 1). Corruption is also often associated with high levels of "bureaucratic redtape", which consequently affects the efficiency of doing business (World Bank, 2002: 1). Corruption makes the host country's bureaucracy less transparent, and therefore having to pay bribes and deal with official extortion "acts as a tax on foreign investors" (Smarzynska & Wei, 2002: 1; Mascarenhas, 2001: 1). Although corruption will result some foreign investors leaving the country it is important to remember that opportunities for business and investment still exist. For example, a large domestic consumer market, natural resources, and inexpensive labour market. Despite corruption the PRC still offers significant business opportunities and does not present any formal barriers to foreign investment such as war or significant social unrest. Foreign investors, such as multinational companies, that can afford to make long-term investments, and have the necessary resources to deal with inefficiencies and other problems, can still reap benefits of their investments.

Under the "Golden Cage Scenario" foreign investors are faced with an external conflict between two most powerful countries in the world, as well as, with rising internal unrest. The conflict between the PRC and the US is particularly going to harm the US and its allies business interests. The majority of Chinese are most likely to support domestic products and services, as well as, policies attempting to limit the influence of foreign businesses. Therefore, opportunities for doing business in the PRC will be limited, and to manage risks will be increasingly difficult. Foreign investors are advised to delay their plans for doing business in the PRC. Opportunities for foreign investors from countries that decide to ally with the PRC, however, are likely to face increased opportunities.

Prospects for profitable foreign investment is especially badly affected under "the Revolution" scenarios. The seriousness of the internal conflict suggests that the best way to manage risk under this scenario is that foreign investors move their operations into regions that are more peaceful. Foreign investors in general cannot expect to reap large profits or guarantee the safety of their employees under this circumstance.

5.8 Summary and Conclusions

The aim of this research assignment was to discover out the types of political risks foreign investors might confront in the future PRC. The starting point for the investigation of political risks in the PRC was the introduction of political risk analysis in the second chapter. The conclusion regarding political risk analysis was that there is no consensus on the definition of political risk, or that any systematic method of conducting political risk assessment exists. However, the main objective of political risk assessment methods, whether qualitative or quantitative, is to describe, explain, and forecast political conditions and events that affect the interests of foreign investors operating abroad or planning to enter a foreign market. In addition, political risk analyses attempt to forecast losses, and recommend means of managing the risk, avoiding the losses, and seizing the opportunities.

The third chapter introduced a qualitative forecasting tool called scenario-planning method. Although it was confirmed that the future cannot be forecast or predicted with certainty, the conclusion was that the very process of thinking about the future and exploring the implications of possible future scenarios may have a profound impact on foreign investment. Scenario-planning is a method that can provide insightful information necessary to understand, anticipate and respond to change and uncertainty in an increasingly complex world.

The fourth chapter reviewed the current economic, political and social developments, trends and driving forces affecting the PRC's investment environment today and possibly in the future. The trends that are likely to impact foreign investment in 2022 include increasing poverty, income disparity, unemployment, labour force stability, economic growth, government actions and policies, changes in leadership, openness of political system, military capacity, efficiency of legal and banking systems, occurrence of ethnic and religious conflicts, and so on.

In the final chapter, four scenarios were developed to illustrate possible futures for the PRC. The first scenario, 'Investor's Paradise', created a picture of economically viable and democratic PRC in year 2022. The second scenario, 'Turbulences', portrayed the PRC as a country troubled by a weak economy and a struggling democracy. In the third scenario, 'Golden Cage', the PRC's political system remained the same, coupled with high economic

growth. And the last scenario, “Revolution”, depicted a story of the PRC under tightening authoritarian rule and facing the pressures of weak economy.

As the scenarios illustrated the prospects for foreign investment can be both positive and negative. If the economy continues to grow strongly, and the government maintains a stable environment and successfully implements the necessary changes foreign investors will reap the desired profits. However, if the problems facing the PRC at the moment further deteriorate foreign investors can expect increased risks, and the possibility of failure.

As this research assignment has demonstrated the scenario-planning method as a forecasting tool provides insightful information necessary to understand, anticipate, and respond to future change and uncertainty. Although the PRC’s future cannot be predicted with certainty, scenarios help foreign investors to confront the unfavourable turn of events with confidence and calmness, anticipate and understand risk, and face the challenges with an awareness of different pathways to the future (Fahey & Randall, 1998: 3; Wack, 1985: 146).

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